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History of the Combat Zone Tax Exclusion

Brandon R. Gould, Project Leader
Stanley A. Horowitz, Task Leader

September 2011

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Executive Summary

Exclusion of military pay from federal income taxes has been a longstanding element of U.S. policy on war finance, combat compensation, and revenue collection in combat zones. The Combat Zone Tax Exclusion (CZTE) was originally established to alleviate the burden of war finance from those who fought in the nation's conflicts. During World War (WW)II, combat tax benefits were separated from war finance policy and became a permanent component of combat compensation. Over time, administrative policies and changes to the tax code have eroded the tax exclusion's traditional purpose, while generating an unintended distribution of benefits. At present, the CZTE neither serves its original purpose nor its later historical role of selectively rewarding those who face a high level of combat risk.

The CZTE was originally created to exempt servicemembers from income tax increases required to finance WWI and WWII. The first income tax exclusion, established in the Revenue Act of 1918, fully offset across-the-board cuts in the personal income tax deduction with a $3,500 tax exclusion for active military personnel. The policy was reprised in the Revenue Act of 1942 through a $250 ($300 for married members) exemption that precisely offset a contemporaneous cut in the personal deduction. Unlike its WWI predecessor, the 1942 exclusion was not available to commissioned officers. Legislative history indicates that the Congress's purpose for both exclusions was clear: those who fought the nation's wars should not bear the "double burden" of financing the conflict. The Congress's intention in 1942 was to rescind its exclusion when prewar tax rates were restored after the conflict, as it did following WWI.

In addition to exempting servicemembers from the burden of war finance, WWI and WWII saw the development of a set of additional military tax benefits, such as suspension on time limits for tax activities and forgiveness of unpaid income and estate taxes for deceased members. These benefits, intended to operate independently of the income tax exclusion, were seen as instrumental to the functioning of a fair tax system for members of the armed services.

Despite its historical ties to wartime finance, the income tax exclusion quickly became a component of combat compensation. One year after the Revenue Act of 1942, Congress replaced the $250/$300 enlisted exclusion with a flat rate $1,500 exclusion available to all personnel, including officers. Motivated by the precedent of the larger WWI exclusion, the new benefit level was established without reference to broader changes in income tax policy, permanently separating the tax exclusion from issues of

wartime finance A modification in 1945 retroactively introduced the modern structure of the tax exclusion, which allowed enlisted members to exclude all military compensation from income tax while limiting officer exclusions to a fixed amount. This new standard established a parity between the level of exclusion for senior enlisted (E-9, >10 Years of Service (YOS)) and commissioned officers, which has only recently been discarded.

Despite the restoration of lower tax rates following the cessation of hostilities, wartime military tax benefits continued until 1949, to induce retention and recruitment in the absence of overall military pay raises. Although the WWII benefits were suspended in 1949, the Revenue Act of 1950, which preserved the structure and distribution of previous benefits (all income excluded for enlisted members and $200 per month for officers), ratified income tax exclusions as a permanent component of combat compensation independent of the demands of war finance.

The income tax exclusions of the latter half of the twentieth century were justified as compensation for members exposed to wartime risks. In the absence of a global military mobilization, the Revenue Act of 1950 conditioned benefits on an individual's presence in a "combat zone" as designated by the president. Unlike in WWI and WWII, the physical location also determined eligibility for preexisting "instrumental" tax benefits such as time suspension provisions and tax forgiveness for deceased, captured, or missing members. Presidential designation of combat zones was intended to enhance the flexibility of administering combat tax benefits with regard to Cold War conflicts. In the Korean War, these goals were achieved with a timely extension and termination of the combat designation. However, in future conflicts, reliance on designations by the president hindered the timely modification of combat tax benefits and diluted their alignment with combat risks.

During the Vietnam War, the structure and distribution of the tax exclusion remained largely in place. A raise in the maximum officer exclusion to $500 per month restored the former level of parity between senior enlisted and commissioned officers.

Although the structure remained intact, the administration of combat tax benefits came into question. Over the course of the conflict, pressure mounted to extend the Vietnam designation to areas with varying levels of risk outside of the formal combat zone. The Air Force, backed by the Department of Defense (DoD), repeatedly endeavored to extend combat designations to low-risk, support areas in Thailand. Though thwarted by the Treasury Department, the proposal set the precedent for designation of low-risk areas in addition to actively contested zones.

The entanglement of "instrumental" benefits with designations for income tax exclusions yielded unintended administrative inefficiencies and inequities during Vietnam. Servicemembers killed, captured, or missing in Cambodia, though eligible for income tax exclusions by virtue of their formal deployment location, were ineligible for

“instrumental” benefits despite enduring comparable risks to those in Vietnam. This inequity persisted until Cambodia was effectively designated in 1968. Unlike in Korea, American withdrawal from Vietnam did not result in the termination of combat tax benefits for Southeast Asia. To maintain tax benefits for servicemembers in POW/MIA status, the combat zone remained active until the United States normalized relations with Vietnam in 1996. These two administrative issues—extension of combat zone designations past the end of hostilities and the difficulty administering “instrumental” tax benefits—persist to the present day.

During the 1990s, the relationship between risk and reward in the tax treatment of military compensation weakened. For the first time, designations were issued to support areas with lesser combat risks. Although the Vietnam combat zone did not include areas such as Thailand and Guam, the Persian Gulf combat zone extended beyond actual combat areas like Iraq and Kuwait to encompass low-risk support areas including Qatar, Bahrain, and the United Arab Emirates. Just as dependence on the designation of combat zones changed the original justification for tax exemption, the inclusion of combat support areas was inconsistent with its revised objective, reward for wartime risks. Once designated, servicemembers deployed to both high- and low-risk areas of the Persian Gulf continued to receive tax benefits until the present day, despite the absence of combat operations for much of the 1990s.

The lowered risk threshold and delayed withdrawal of benefits characteristic of the Persian Gulf combat zone was reprised in the congressionally initiated “Qualified Hazardous Duty Area” (QHDA) designation for Bosnian peacekeeping operations. Although there were fewer than 20 military deaths (and only one recorded hostile fatality), tax benefits for the Balkans persisted from 1996 to 2007. Because the QHDA designation remains in effect, tax benefits for the entire area could be revived through an isolated, event-based restoration of Hostile Fire Pay/Imminent Danger Pay.

Even with lengthier designations and lower risk thresholds, the dependence of “instrumental” benefits on combat zone designations remained problematic throughout the 1990s. The absence of a designation for combat operations in Somalia, while arguably defensible from the perspective of the income tax exclusion, resulted in the denial of posthumous tax benefits to soldiers killed in Operation Restore Hope. The 1990s also witnessed a change in the distribution of combat zone tax benefits. As discussed above, previous revisions of the CZTE in 1945, 1950, and 1966 had established a standard of parity in the level of benefits between senior enlisted (specifically, an E-9 with more than 10 YOS) and commissioned officers. Historically, enlisted members were able to exclude all military compensation from the income tax while commissioned officers could only exclude pay up to a specified level. In 1990, the Congress attempted to preserve the former level of parity by updating the officer exclusion to $2,000 per month, but the legislation was preempted by Executive Order 12744, which established

the Persian Gulf combat zone. In 1996 the authorization of the Balkans QHDA included an increase to the officer exclusion to the "maximum enlisted amount." The "maximum enlisted amount" was interpreted as the pay of the Senior Enlisted Advisor—equaling $4,104.90 per month. Basing all officer exclusions on the pay of the six most senior enlisted servicemembers resulted in an exclusion amount over 55 percent higher than the historical standard of parity (which would have yielded a maximum exclusion of $2,623.20 per month). Later in that same year, the distributional shift in benefits toward officers was exacerbated by a significant expansion in the Earned Income Tax Credit, for which many officers in designated combat zones were now eligible (because a large part of their earnings was not counted as taxable income).

Contents

1. Introduction 1
2. Bearing the Fiscal Burdens of War 3
   A. World War I.....3
   B. World War II (1941–1942).....5
3. Development of the Modern Tax Exclusion as a Part of Combat Compensation.....9
   A. World War II (1943–1949).....9
   B. Korea 12
4. Conflict over the Meaning and Administration of Vietnam Tax Benefits 15
5. Current Tax Exclusion: Revising the Relationship between Risk and Reward 21
Illustrations A-1
References.....B-1
Abbreviations.....C-1

1. Introduction

Exclusion of military pay from federal income taxes has been a longstanding element of how the nation finances wars, collects revenue, and compensates members of the Armed Services deployed abroad in areas of combat risk. For nearly as long as the federal government has taxed its citizens' income, soldiers fighting the nation's wars have been exempted from taxation on some or all of their income arising from wartime service. Taxes forgiven by the combat zone tax exclusion (CZTE) result in a direct monetary benefit to individual servicemembers and constitute an integral part of overall combat compensation. In addition to the CZTE, the Congress has historically authorized a series of more narrowly-focused tax benefits that correspond to particular circumstances of combat service. Posthumous exemption from estate and unpaid income taxes fit this category, as do income tax exclusions for missing and captive servicemembers. Similarly, servicemembers are exempted from time provisions, tax withholding, and interest accrual due to the difficulties inherent in fulfilling routine tax obligations in a combat zone. Such benefits, separate from the CZTE, have been viewed as "instrumental" to the functioning of a fair tax system. The CZTE and other "instrumental" benefits have greatly reduced the financial and administrative burden of federal taxation upon members of the Armed Forces serving in major foreign conflicts over the past century.

The purpose of this paper is to detail the historical development and administration of combat tax benefits, with particular emphasis on the federal income tax exclusion. In each of the following chapters, the paper discusses the major legislative and administrative changes to tax benefits for a specific time period and highlights the influence of changing combat environments, conflicting benefit justifications, and evolving policy on military pay and federal tax policy on the CZTE. Chapter 2 details the origins of the first tax exclusions as the nation's response to the proper allocation of the burdens of war finance in World War (WW)I and II. Early tax exclusions served a specific and limited purpose, namely to ensure those who fought did not bear a double burden of paying for war. Chapter 3 covers the exclusions for the latter half of WWII and Korea. At the end of WWII, wartime tax exclusion became a permanent part of the tax code. In Korea the benefit became linked to combat and risk for the first time. During this period, tax exclusions were justified primarily for their incentive value in the absence of higher levels of military compensation. Chapter 4 details debates over the applicability of combat benefits to circumstances of varying risk in the Vietnam conflict environment. The bureaucratic debates over Vietnam-era benefits foreshadow the administrative and

distributional issues surrounding combat tax benefits in modern settings, which are discussed in Chapter 5.

2. Bearing the Fiscal Burdens of War

For much of its history, the United States has been characterized by a limited federal government with a small standing army. Historically, the advent of war required both the muster of a military and the raising of revenues. The need for both soldiers and dollars to fight wars placed two burdens on the nation's citizenry. The principal burden was placed upon the soldiers called to fight. The second, required of the nation's taxpayers, was smaller and spread more evenly across the citizenry. In conflicts since the Civil War, the nation judged that those who shouldered the greater sacrifice should not be doubly charged with the lesser. Such was the policy behind the early tax exclusions in WWI and II, where compensation for members of the armed services was specifically excluded from the increased rates of taxation required to finance war.

A. World War I

The history of the CZTE began with the enactment of the first federal income tax. Prior to the Sixteenth Amendment[1] and subsequent Tariff Act of 1913, the government raised revenue through import duties, fees, and excise taxes, rather than levies on earned income. For a brief period during the Civil War, the Confederacy authorized an income tax containing exemptions for military compensation, but the Union did not follow suit with its wartime income tax in 1862.[2] The 1913 Tariff Act allowed single persons to exempt the first $3,000 of earned income from taxation through the personal exemption. Married persons could exclude the first $4,000. With the median income in 1913 at $733, only two percent of the labor force was subject to taxation.[3] Entry into WWI demanded substantial revenue increases, and, in response, the Revenue Act of 1918 reduced personal exemptions to $1,000 for single and $2,000 for married persons, quintupling the number of prospective taxpayers. Accompanying the tax hike was a provision excluding

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[1] The Sixteenth Amendment to the U.S. Constitution, ratified in 1913, allowed the federal government to directly tax earned income, which had been ruled unconstitutional by the U.S. Supreme Court in *Pollock v. Farmers' Loan & Trust Company*.

[2] Patrick Kusiak, *Exclusion from Gross Income during War or in Combat Zones*. Report for Military Personnel Policy (Compensation), 1996.

[3] Thomas Piketty and Emmanuel Zaez, *Income Inequality in the United States, 1913–2002*, November 2004. Table A0, Appendix.

active military compensation earned during the war up to a cumulative total of $3,500 per year from the income tax.[4]

Although the Congress did not hold hearings on the military exclusion, the legislative history makes clear its intended purpose and scope. The provision's presence in a bill lowering personal exemptions by $2,000 suggests a desire to maintain servicemembers' tax liabilities at roughly prewar levels. This benefit was not intended to supplement overall military compensation. Notably, proposals to exclude all military income from taxation (including income above $3,500 per year), offered by the Senate, were rejected in the Conference Committee.[5] Service in war absolved a soldier from paying for the conflict, but not from the broader obligations of citizenship. Later congressional testimony expressly stated the existence of a consensus surrounding the "[belief] that members of the armed service [should not] be required to bear this increased burden" of taxation for financing war.[6]

During the bill's progress through the Congress, several amendments reflected the desire to limit the exclusion to those serving at war. From the start, pensioners and disabled members were excluded from the tax benefits, and the initial House bill further limited eligibility to "services [performed] abroad or at sea." Fearing the administrative difficulties involved in determining deployment status, the Senate instead constrained benefits to "active service" in "the period of the present war," allowing the exclusion to expire upon cessation of hostilities.[7] Eligibility for benefits based upon geography, a hallmark of later exemptions, may have been unnecessary during a time of full military mobilization when the entire force faced reasonable expectations of combat deployment in Europe. Following the end of the war, tax benefits were automatically curtailed on July 2, 1921, and the statutory authority for tax benefits was repealed by the Congress shortly thereafter.[8]

Accompanying the WWI tax exclusion were two other "instrumental" tax benefits for military service: a provision excluding taxes on entertainment admissions (intended to exempt soldiers from taxes on United Service Organizations events) and, more importantly, forgiveness of inheritance tax for soldiers dying during the war or from injuries up to one year thereafter. The latter provision, like the broader income tax

---

4 S. Rep. No. 65-617, 3rd Sess. (daily ed. December 6, 1918). The $3,500 exclusion was inclusive of an individual's personal exemption. Therefore, for single persons, the benefit would amount to an additional $2,500 exclusion; for married individuals, the additional exclusion would be $1,500.

5 H.R. Rep. No. 65-1037, 3rd Sess. (1919).

6 H.R. Rep. No. 77-2333 (daily ed. July 14, 1942).

7 S. Rep. No. 65-617, 3rd Sess. (daily ed. December 6, 1918).

8 Revenue Act of 1921, Chapter 136, 42 Stat. 227 (1921).

exclusion, offset a substantial increase in the inheritance tax rate.[9] While the income tax exemption was capped at $3,500, the inheritance tax exemption had no upper limit, suggesting that the Congress felt that those dying from hostile action should receive stronger consideration than those serving in conflicts. From the start, such "instrumental" benefits were intended to operate separately from broader income tax exclusions.

The WWI tax exclusion affected relatively few members of the armed services; despite substantial income tax increases, only a small fraction of soldiers would have paid income tax in the absence of the exclusion. Maximum enlisted pay during WWI was roughly $1,200 per year, slightly above the $1,000 personal exclusion for single individuals. As a result, only the most experienced (single) enlistees benefited from the exclusion, and their overall benefit was minimal.[10] Officers received the majority of the benefits. Officers of the rank of Major (O-4) and above received the full benefit of the exclusion, valued at $240.[11] Lower-ranking officers received partial exclusions, with O-1 exclusions comparable to that of the maximum enlisted exclusion. The legislative history suggests that the officer-oriented distribution of benefits was an artifact of the then-sizeable personal exclusion, rather than a conscious effort to benefit officers.[12] After tax brackets crept downward in the interwar period, the Congress's resolve to exclude servicemen from the fiscal burdens of war remained intact, prompting the reenactment of tax benefits at the beginning of WWII.

B. World War II (1941–1942)

Initially, WWII benefits followed the WWI precedent. Entrance into the war immediately required substantial revenues, which were furnished through reductions in the personal exemption from $750 to $500 for single individuals and from $1,500 to $1,200 for married couples. The precedent of the WWI tax exclusion held sway over the debate of whether soldiers and sailors should be subjected to the tax increase:

> Your committee is of the opinion that a special allowance should be made for the relief of soldiers and sailors in active service. During the last World War, the revenue law contained a special exclusion from gross income to take care of this situation. In lowering the exemptions for taxpayers

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[9] S. Rep. No. 65-617, 3rd Sess. (daily ed. December 6, 1918).

[10] A single senior enlisted member with $1,200 in annual income would receive a $12 benefit from the tax exclusion.

[11] Tax Foundation, *Tax Data: U.S. Federal Income Tax Rates History, 1913–2011*. January 2011. Assumes a single O-6 with $5,000 annual income (the maximum) and tax brackets of 12 percent above $4,000 and 6 percent below $4,000 who would otherwise receive a $1,000 personal exemption. Officers with pay below $5,000 but above $3,500 would receive slightly lower exemptions due to less income excluded under the above $4,000 tax bracket.

[12] H.R. Rep. No. 77-2333 (daily ed. June 14, 1942).

> generally, your committee does not believe that members of the armed service should be required to bear this increased burden.[13]

As in the WWI bill, the House of Representatives proposed annual exclusions of $250 for single and $300 for married individuals to completely offset proposed tax increases in the Revenue Act of 1942. Again, the fundamental fairness of exempting military personnel from bearing the financial burdens of war was cited as justification for the tax exclusion. The Senate agreed on the level of exclusion, but "[limited the] exclusion to personnel below the grade of commissioned officer."[14] This provision marked the first instance of differential tax treatment between commissioned officers and enlisted personnel, a distinction that has been maintained until the present day. The absence of an exclusion for commissioned officers suggests that the Congress intended to provide greater benefits to enlisted members than commissioned officers.

In addition to the enlisted tax exclusion, WWII saw the development of a broader set of "instrumental" tax benefits, which continue today. The Soldiers' and Sailors' Civil Relief Act of 1940[15] introduced the first of these benefits by deferring income tax collection (and interest accrual) from members of the Armed Services deployed at war. The act also postponed foreclosure proceedings on servicemember-owned properties stemming from unpaid property tax.[16] That arduous physical deployments and low military salaries impaired soldiers' ability to meet tax obligations justified these benefits. Complete suspension of time limitations on all federal taxes for personnel deployed abroad followed in the Revenue Act of 1942, which also eliminated income tax withholding from military paychecks. Unlike the income tax exclusion at the time, these benefits were available to officers and enlisted personnel alike.[17] To the Congress, these benefits were instrumental in easing the administrative burden "for men who go overseas" and encounter "the difficulty of having access to their books and records and papers."[18] As such, "instrumental" benefits comprised a separate, but also important, goal of wartime tax policy.

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[13] H.R. Rep. No. 77-2333 (daily ed. June 14, 1942).

[14] H.R. Rep. No. 77-2586 (daily ed. October 19, 1942).

[15] The Soldiers and Sailors Civil Relief Act of 1940 authorized a number of protections for members of the Armed Services. Most important of these benefits was the protection of servicemembers from civil suit during their period of active service. The act prevented soldiers from being subject to foreclosures, garnishments, attachments, evictions, and judgments so that active duty members could focus on fighting the war. The provisions of the act have been updated periodically and most recently reauthorized in the Servicemembers Civil Relief Act of 2003.

[16] H.R. Rep. No. 76-3030 (daily ed. October 7, 1940).

[17] H.R. Rep. No. 77-2333 (daily ed. June 14, 1942).

[18] *Current Payments Tax Act of 1943, Hearings on H.R. 2570, Before the Senate Finance Committee*, 78th Cong. (1943).

The Revenue Act of 1943 restored tax benefits upon the death of a servicemember. In addition to an inheritance tax exclusion, the Act exempted deceased officers and enlisted personnel from payment of other outstanding federal tax liabilities, including unpaid income tax and accrued interest on both military and non-military compensation.[19] The greater generosity of tax benefits to soldiers dying in uniform corresponded to their greater sacrifice in service of their country. Under complete military mobilization during WWII, the newly developed set of "instrumental" tax benefits could remain independent of the more widely available tax exclusion.

[19] Ibid.

3. Development of the Modern Tax Exclusion as a Part of Combat Compensation

A. World War II (1943–1949)

The initial tax exclusion for WWII did not last long. Within a year, the Congress debated and passed far more generous provisions that divorced tax benefits from wartime finance. Eventually, benefits were employed to compensate servicemembers for the risks of combat deployment and counteract low military—especially enlisted—pay levels. The separation of tax exclusions from war finance allowed tax benefits to become a permanent component of tax law and combat compensation. The structure of modern tax benefits has its roots in the policy decisions made during this period.

Almost immediately after the passage of the 1942 income tax exclusion, the Congress began debating its replacement. While the concept of military tax exclusion received almost unanimous support, some in the Congress believed that the existing exclusion of between $250 and $300 was insufficient. Legislative debate focused on the $3,500 exclusion for military personnel in WWI, despite the fact that falling income tax brackets and rising pay levels had made existing benefits more generous than their 1918 predecessors. In its first attempted revision, the House of Representatives revisited the WWI $3,500 total exemption for both single and married members.[20] Unlike the 1942 law, officers would also be eligible for the revised tax exclusion.[21] Despite the move away from matching tax benefits to wartime revenue collection, the Congress maintained that the purpose of tax benefits as an expression of national solidarity remained the same, as the exchange below illustrates.

> Sen. BARKLEY: Is [the exclusion] supposed to be in the bill based upon the service of the man in the armed services as such or based upon his comparative need for the exclusion?
>
> Mr. SURREY (Treasury Dept.): No it is based upon his service as such.[22]

The $3,500 exclusion passed the House, but the bill stalled in the Senate. Technical issues of eligibility for soldiers serving stateside, differentials between married and single benefits, and

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[20] The House proposal was for a $3,500 exclusion that combined the military exclusion and the personal exemption, as in WWI. A single individual would receive a $500 personal exclusion and a $3,000 military exclusion. Corresponding married exclusions would be $1,200 and $2,300, respectively.

[21] *Current Payments Tax Act of 1943, Hearings on H.R. 2570.*

[22] Ibid.

the cumulative nature of the exclusion were resolved by a simplifying compromise.[23] All servicemembers, whether officers or enlisted, serving domestically or abroad, could exclude up to $1,500 of military compensation from income tax, in addition to any other exclusions. The Senate version passed Conference Committee and was signed into law.[24]

Enactment of this provision marked a departure from previous tax exclusions. Both the 1918 and 1942 laws linked the generosity of tax exclusions to changes in taxation required to finance wars.[25] With the 1943 bill, this connection was permanently removed.

The $1,500 annual exclusion, when combined with a personal exemption of between $500 (single) and $1,200 (married), meant that almost all enlisted personnel (excepting single E-7s with extended years of service) would have no tax liability. Assuming marriage, most low-ranking officers (below O-3) would be completely exempt, and all higher-ranking officers (O-4 and above) would receive the maximum income exclusion but pay some amount of income tax, regardless of experience. As a result of this exemption, 90 percent of all servicemen had no federal tax liability prior to 1945.[26] The bill also set a precedent for parity between officer and enlisted exclusions. At $1,500, the maximum officer exclusion was comparable to the $1,656 minimum pay for senior enlisted members (E-7) (see Figure 1, which does not consider personal exemptions). This standard of parity would be upheld in subsequent revisions of tax benefits until revised by recent legislative changes.

LEGEND

Pays no tax (1943)
Pays no tax (1945)
Receives full $1500 exclusion

Enlisted Rank	Min	Max	Officer Rank	Min	Max
SFC (E7)	**$1656**	$2484	Col (O6)	$4000	$6000
SSgt (E6)	$1368	$2052	LtCol (O5)	$3500	$6000
Sgt (E5)	$1152	$1728	Maj (O4)	$3000	$5250
Corp (E4)	$936	$1404	Capt (O3)	$2400	$4500
PFC (E3)	$792	$1188	1st Lt (O2)	$2000	$3600
Pvt (E2)	$648	$972	2nd Lt (O1)	$1500	$3000

Source: Defense Finance and Accounting Service (DFAS), Military Pay Tables, 1943 and 1945.

Note: Minimum and maximum pay values vary within grades due to a member's years of service (YOS). This applies to subsequent pay tables as well.

Figure 1. Military Annual Pay – Combat Income Exclusions and Pay Grades in 1943 and 1945

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[23] Ibid.

[24] H.R. Rep. No. 78-510 (1943).

[25] Ibid. The legislative language of the 1942 exclusion makes the purpose clear: "If the taxpayer is in active service in the military or naval forces of the U.S. or any of the other United Nations at any time during the taxable year 1942 or 1943, the increase in the tax for the taxable year 1943…shall be reduced by an amount equal to the amount by which the tax for the taxable year 1942…is increased."

[26] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

Severing the connection between tax exclusions and war finance altered the fundamental purpose of the military tax exclusion. Without reference to offsetting tax increases, the exclusion supplemented other forms of military compensation. Changes to the tax exclusion in the immediate postwar period reflect this shift from allocating the burdens of war to increasing overall levels of military compensation. The Revenue Act of 1945, which passed after Japan's surrender, lowered marginal tax rates and exempted all enlisted compensation from federal income tax, retroactive to January 1941. The exemption for commissioned officers remained at $1,500 per year, and although the Congress extended payment deadlines, the officer exemption was not made retroactive.[27] Full enlisted exclusion had little practical effect for the period from 1943 to 1945, as very few enlisted members paid taxes under the 1943 law. However, retroactivity resulted in a substantial windfall tax refund to enlisted personnel serving in 1941 (even prior to Pearl Harbor) and 1942 (when the smaller tax exclusion was in place). Although the 1945 exclusion did not receive significant congressional debate, an unpublished study by Patrick Kusiak suggests that the post-1945 tax refunds served to "[increase] the competitiveness of otherwise modest pay levels," for enlisted recruits.[28]

In addition to retroactively exempting all enlisted compensation from federal income tax, the Congress, the Military Departments, and the Truman administration extended eligibility for tax benefits past the end of WWII. As with the new enlisted exemption, the purpose of continued tax benefits was to address broader manpower goals. Although Japan surrendered in August of 1945, hostilities were not officially terminated until December 31, 1946. Following the official termination of hostilities, the House introduced a bill curtailing all wartime tax benefits at the end of 1947. As noted by Kusiak, this proposal met with strong opposition from the military:

> Exemption from income tax had become an important element of military compensation. It played a prominent role in efforts of the Military Departments to recruit volunteers….In the event the exclusion for the military could not be continued, the War and Navy Departments urged a delay in the termination of the wartime exclusion to permit an offsetting increase in military pay.[29]

Sympathetic to these concerns, the Senate proposed extending the window of benefits eligibility for enlisted personnel to the end of 1948. A one-year delay in the phase-out of enlisted benefits allowed time for offsetting pay increases. In Conference, the House concurred on extending the enlisted benefits deadline, but also desired continuation of officer exclusions, and the final bill extended wartime tax exclusions for all members until January 1, 1949.[30]

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[27] S. Rep. 79-655 (1945).

[28] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[29] Ibid.

[30] Ibid.

B. Korea

Termination of tax benefits would last only until the outbreak of the Korean War. While many of the statutory provisions of the WWII tax benefits were reinstituted, the new reality of fighting a geographically limited "policing" operation, as opposed to full military mobilization, prompted changes in the administration of the tax benefits. These new mechanisms formed the foundation of the administration of current tax benefits based upon presence in a geographically designated combat zone, and established the relationship between risk and reward that would characterize the administration of tax benefits over the coming decades.

The Revenue Act of 1950 authorized tax benefits for service in Korea. Originally intending to reduce tax rates following post-WWII military demobilization, the Congress instead increased taxes in response to the North Korean invasion. As in the 1918 and 1942 revenue bills, the Congress proposed a military tax exclusion for service in the conflict. Many provisions of the 1943 exclusion remained intact. All enlisted military compensation earned in Korea would be excluded from federal income tax, most of the "instrumental" benefits were reauthorized, and up to $200 per month of commissioned officer pay earned in Korea was exempted from income tax.[31] The geographic limitation of a combat zone reflected the intent to provide benefits as a compensation for risk. The raise to a $200 per month benefit ($2,400 annually) maintained the parity between the maximum exclusions for officers and senior enlisted personnel that prevailed in WWII. The quote below from a Senate Finance Committee Report suggests the Congress's desire to maintain officer/enlisted benefits at this standard of parity (see Figure 2):

> The WWII exclusion for commissioned officers was a maximum of $1,500 annually as compared with a maximum of $2,400 under this bill. It is believed that this increase is advisable to achieve a greater degree of equality in treatment as between enlisted men and officers.[32]

LEGEND
Pays no income tax
Receives full $200 exclusion

Enlisted Rank	Min	Max	Officer Rank	Min	Max
SFC (E7)	**$198**	$294	Col (O6)	$570	$698
SSgt (E6)	$169	$250	LtCol (O5)	$456	$584
Sgt (E5)	$140	$228	Maj (O4)	$385	$513
Corp (E4)	$118	$191	Capt (O3)	$314	$442
PFC (E3)	$96	$147	1st Lt (O2)	$249	$349
Pvt (E2)	$83	$120	2nd Lt (O1)	$214	$314

Source: DFAS, Military Pay Tables, 1949.

Figure 2. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1950

[31] S. Rep. No. 81-2375 (daily ed. July 20, 1950).

[32] S. Rep. No. 81-2375.

By the time of the Korean War, pay raises had reduced the need for a wartime tax benefit as a general increase in compensation. The Korean policy modified the justification for the tax exclusion, from retention and recruitment incentives to compensation for combat risk. Inclusion of the combat zone income tax exclusion in Section 112 of the 1954 Internal Revenue Code reinforced the exclusion's new and permanent status as an element of combat compensation.[33]

During the Korean War, important changes were also made to the administration of tax benefits. Whereas previous income tax exclusions and "instrumental" benefits were available to all servicemembers regardless of deployment location, eligibility for postwar benefits was determined by presence within a defined combat zone. This change aptly reflected the geographically limited nature of the then-current conflicts and the Congress's desire to relate risk to reward, but the new administrative arrangements posed issues of their own. While presence in a combat zone may have been appropriate for monthly income tax exclusions, it arguably proved a less efficient and flexible standard for administering time suspension provisions, posthumous tax forgiveness, and other "instrumental" tax benefits.

Linkage between geographic combat zones and "instrumental" benefits was not inevitable; indeed, such benefits were originally intended to operate separately from the income tax exclusion. When restricted by geography, the administration of "instrumental" benefits would encounter difficulties dealing with soldiers captured or killed outside defined combat zones or prisoners remaining in designated areas after the cessation of combat operations in the Vietnam War and beyond. Because the DoD resisted congressional attempts to provide tax benefits to prisoners of war in 1954,[34] the reliance on designated combat zones for both tax exclusions and certain "instrumental" tax benefits did not give rise to the aforementioned equity concerns in Korea as it would in later conflicts.

The Revenue Act of 1950 not only extended benefits to soldiers deployed to the Korean Peninsula, but authorized the president to designate (and undesignate) future combat zones by Executive Order.[35] Executive discretion arguably would preclude the need for congressional intervention and introduce a greater degree of flexibility and responsiveness to the administration of tax benefits in response to changing risk circumstances. For the Korean War, this presidential power went unused, as the Congress twice extended the window of benefits beyond the original deadline of January 1, 1952.[36] However, as discussed in Chapter 4, the Congress's delegation of authority to the executive branch unintentionally invited future inter-agency debates over the purpose of and eligibility for tax benefits. In future conflicts, the DoD favored broader application of benefits to increase the attractiveness of combat compensation without penalty to military budgets, while the Department of the Treasury preferred narrow application and

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[33] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[34] Ibid.

[35] S. Rep. No. 81-2375.

[36] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

questioned the fundamental purpose of the CZTE. Tasked with mediating this debate, future administrations often proved *less*, not *more* flexible than the legislature, frustrating congressional advocates for combat tax relief. By conferring benefits on the basis of geography and delegating "combat zone" designation to the executive branch, the Korean War benefits set the stage for the administrative debates concerning military tax benefits in Vietnam and beyond.

4. Conflict over the Meaning and Administration of Vietnam Tax Benefits

The authorization of combat tax benefits to Vietnam lagged behind the advent of combat operations. Although deployments of military advisors and subsequent casualties began as early as 1959, Vietnam was not designated as a combat zone under Section 112 of the Internal Revenue Code until the war escalated in 1965. Prior to 1965, there was some debate on granting benefits; however, neither legislation nor a presidential designation was forthcoming. Following the Gulf of Tonkin Resolution, Executive Order (E.O.) 11216 authorized benefits retroactive only to January 1, 1964.[37] Whereas the WWII and Korean designations were retroactive to the onset of combat operations, the Vietnam combat zone designation excluded a three-year period in which over 15,000 soldiers were deployed and 200 were killed.[38]

The only legislative change to combat tax benefits occurred relatively early in the official conflict. In November 1966, the Congress, at the urging of the administration and the DoD, raised the maximum officer income exclusion from $200 to $500 per month. The Committee on Ways and Means supported the bill unanimously and it passed without difficulty. The legislative history suggests that the Congress intended to restore the traditional standard of parity between officer and enlisted exemptions (see Figure 3):

> When these exemptions were last revised—during the Korean conflict—it was intended that the exemption would benefit commissioned and senior noncommissioned officers on an approximately equal basis. However, the seven military pay raises which have been enacted since the exemptions were last revised have upset the intended balance. Currently, some senior noncommissioned officers receive approximately $500 completely exempt from tax…Your committee believes that this increase [to $500] would restore the traditional balance between the combat pay exclusion for commissioned officers and enlisted men.[39]

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[37] Exec. Order No. 11216, 3 C.F.R. 301 (1964-65). *Designation of Vietnam and Waters Adjacent Thereto as a Combat Zone for the Purposes of Section 112 of the Internal Revenue Code of 1954*.

[38] DoD Statistical Information Analysis Division, *Military Personnel Statistics: Active Duty Military Personnel by Service by Region/Country*, Historical Reports, 2011; National Archives, *Vietnam Conflict Extract Data File: Record Group 330*, April 29, 2008, http://aad.archives.gov/aad/fielded-search.jsp?dt=2354&cat=WR28&tf=F&bc=,sl.

[39] H.R. Rep. No. 89-2270 (daily ed. October 13, 1966).

LEGEND
Pays no income tax
Receives full $500 exclusion

Enlisted Rank	Min	Max	Officer Rank	Min	Max
SgtMaj (E9)	**$511**	$657	Col (O6)	$704	$1217
MstrSgt (E8)	$428	$587	LtCol (O5)	$563	$992
SFC (E7)	$269	$529	Maj (O4)	$475	$830
SSgt (E6)	$232	$388	Capt (O3)	$442	$718
Sgt (E5)	$200	$329	1st Lt (O2)	$354	$533
Corp (E4)	$169	$253	2nd Lt (O1)	$304	$420

Source: DFAS, Military Pay Tables, 1966.

Figure 3. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1966

Officer incentives also motivated this change. Without restoration of the historical balance, the Congress feared the existence of a "possible tax impediment to the acceptance of battlefield commissions by eligible enlisted personnel."[40] This concern demonstrated the importance of the CZTE as part of the overall compensation package for wartime service, and was echoed in future debates over extending combat benefits outside the combat zone. References to wartime revenue demands, which supplied the original justification for military tax exclusions, were absent from debate over combat tax benefits in Vietnam.

The shift toward viewing the tax exclusion as an element of overall military wartime compensation had consequences in the debate over extending tax benefits to areas outside Vietnam. As the conflict broadened in scope, combat operations expanded beyond Vietnam into Laos and Cambodia. Combat support operations spread even farther, with substantial deployments in Thailand, Okinawa, and Guam. At the time, the official combat zone designation authorized benefits only to servicemembers deployed to Vietnam. However, although attempts to expand the CZTE to low risk areas were unsuccessful, they presaged future eligibility for soldiers performing support operations in areas of limited combat risks. Furthermore, a slow-moving bureaucratic process delayed benefits to some deserving personnel outside of the formal combat zone.

Delayed eligibility for Laos and Cambodia marked the most clear-cut case of the difficulties administering combat tax benefits, even with widespread political support. Unarguably, soldiers operating on the perimeter of Vietnam manned the frontlines of the conflict. Servicemembers temporarily present in Laos and Cambodia continued to receive federal income tax exclusions because their official deployments remained within the combat zone. However, presence outside Vietnam stripped eligibility for "instrumental" benefits servicemembers could receive should they be injured, killed, or captured.[41] For example, a

[40] Ibid.

[41] Kusiak, *Exclusion from Gross Income During War or In Combat Zones.*

member deployed to Vietnam but dying in Cambodia would receive an income tax exclusion, but would not receive posthumous exemption for any inheritance and unpaid income taxes. Likewise, the compensation of members injured or captured beyond the borders may have been subject to federal income taxation. This geographic asymmetry ran counter to the original intent that "instrumental" benefits be available regardless of location. Such unintended inequities were direct consequences of the link between eligibility and presence within a designated combat zone.

The subtlety of these differences in eligibility may have delayed correction of these inequities. Over 400 soldiers were killed in Cambodia and Laos before the asymmetry in "instrumental" benefits was corrected in November of 1970.[42] Once the problem was identified, the political system moved rapidly. First, the Congress introduced a bill designating Cambodia and Laos as combat zones. The president countered with a proposal to include a ten-mile radius around Vietnam in the existing combat zone. The forthcoming Executive Order was again preempted by new rules from the Treasury Department (Treasury Directive (T.D.) 7066) that granted full combat zone status to those directly supporting combat operations while outside Vietnam who were eligible for Hostile Fire Pay (HFP).[43] By establishing a durable, risk-based standard for adjudicating future claims, T.D. 7066 was an improvement over both the legislative and executive efforts. However, by the time the rules came into force, the conflict had been underway for the better portion of a decade, and soldiers were not granted retroactive eligibility. The delayed designation of Cambodia and Laos demonstrated that, even with unanimous political support, the administration of combat tax benefits could be difficult and potentially inequitable.

The competing perspectives on extending tax benefits to comparatively safe outlying support areas resulted in a series of inter-agency debates over the meaning of, and eligibility for, military tax benefits. A 1967 Air Force proposal to extend CZTE benefits to ground crews based in Thailand initiated these debates. At the root of the Air Force's proposal was the fact that offshore support personnel in the Navy received income tax exclusions (while inside the designated combat zone), yet air crews in Thailand, whose duties entailed greater everyday risks, did not. Benefits were necessary "to counteract adverse morale problems" caused by this perceived inequity. In a memorandum to the State and Treasury Departments, the DoD backed the Air Force position and recommended extension of the tax exclusion to Thailand.[44]

The Treasury Department, however, held a different perspective. Risks, not incentives, justified the military tax exclusion. In a strongly worded memo, excerpted below, the Tax

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[42] Prior to November 10, 1970, 432 servicemembers were killed in Cambodia. Including those wounded, total casualties in Cambodia numbered 2,848, National Archives, *Records of Military Personnel Who Died, Were Missing in Action or Prisoners of War as a Result of the Vietnam War,* Access to Archival Databases, January 21, 1998, http://aad.archives.gov/aad/fielded-search.jsp?dt=197&cat=WR28&tf=F&bc=,sl.

[43] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[44] Ibid.

Legislative Counsel for the Office of the Secretary of the Treasury argued that, due to the lack of combat risk in Thailand, the extension of tax benefits was not justified:

> there appears to be no need to extend that exclusion to personnel who are not directly engaged in combat operations.…The fact that some personnel stationed in Vietnam are entitled to combat pay exclusion even though they may not actually engage in combat does not justify extension of the combat pay exclusion to noncombatant personnel stationed in Thailand.…Thailand [presents a] situation in which administrative convenience no longer justifies undue generosity.[45]

If benefits were conferred upon noncombatants serving in Thailand, the Under Secretary feared the setting of a precedent for future extensions:

> Extension of the combat pay exclusion to Thailand would be likely to lead to pressure for the designation of additional areas as "combat zones," even though hostile activities in such areas do not constitute open warfare. The Congo and the Dominican Republic were offered as examples of areas in which American forces had recently engaged in combat types activities falling short of open warfare. It did not appear wise to establish a precedent which could result in designating such areas as "combat zones" in the event that limited hostilities were to occur or reoccur in such areas.[46]

From a risk perspective, combat support operations in Thailand, the Treasury argued, deserved no more recognition than similar deployments in Japan, Okinawa, and Guam during the Korean War. The Department of State added that designating such nations as combat zones might imply either a deterioration of diplomatic relations or escalation of internal hazards in the host country.[47] The warning that inclusion of support operations in Thailand would result in pressure to add other areas proved correct. More recent combat zone designations in the Persian Gulf and Balkans, which included combat support areas, can be traced back to the debate over eligibility for Thailand.

A subsequent memo by the Under Secretary of the Treasury expanded the critique beyond the Thai case at hand, to question the historical justifications of the CZTE itself.

> We believe that it is important to remember that the combat pay exclusion provided by Section 112 of the Internal Revenue Code is designed mainly as a substitute for more generous appropriations for hostile fire pay, and as a means of eliminating the need to file tax returns when operating under combat conditions. Neither of these justifications for the combat pay exclusion applies in the case of Armed Forces personnel serving in Thailand.

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[45] Jerome Kurtz, *Letter from Tax Legislative Counsel Jerome Kurtz to Deputy Under Secretary of the Air Force for International Affairs Philip F. Hilbert*, June 19, 1967.

[46] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[47] Assistant Secretary for Congressional Relations, Department of State, *Letter to the Director of the Bureau of the Budget*, June 17, 1968.

> No definite information appears to be available as to the justifications for these income tax exclusions. The World War II exclusion may have been intended as a means of providing additional compensation for armed services personnel, since military pay during the opening years of WWII was quite low. The lack of any geographical limitation on the exclusion, and the delay in extending the exclusion to officer personnel tend to support this view… The justification for the WWI exclusion is less clear. That exclusion appears to have benefited only senior officers, because the high starting brackets under the WWI income tax relieved most enlisted men and junior officers from tax, even without the special exclusion for military personnel.[48]

After questioning the historical justifications for combat tax benefits, the Under Secretary criticized the administration of the tax exclusion in Vietnam. Treasury's objection, summarized by the Kusiak study below, marked the most comprehensive critique of the CZTE to date. It merits mentioning that each of the Under Secretary's criticisms remains relevant to this day.

> As a substitute for more adequate compensation…the existing combat zone exclusion was undesirable because:
>
> 1. Given the progressive nature of the income tax rates, the exclusion confers its greatest benefits on senior officers and its smallest benefits on the lowest enlisted grades.
> 2. The existing exclusion confers its benefits indiscriminately whether or not an individual is in a unit that undergoes substantial risks or hardship during its period of service in a combat zone.
> 3. The exclusion obscures the actual pay costs incurred by the Department of Defense.
> 4. The existence of the exclusion has led to pressure from other Government agencies for similar privileges for their employees, and the employees of their contractors.[49]

Facing opposition from the Treasury, the Pentagon dropped the Air Force proposal. Unable to extend benefits via Executive Order, the DoD supported congressional efforts, led by Senator John Tower (R-TX) of the Armed Services Committee, to designate Thailand as a combat zone.[50] When Tower's efforts stalled, advocates attempted to include Thailand under new Treasury regulations (T.D. 7066) that extended CZTE eligibility to those serving in "direct support" of combat operations based upon receipt of HFP. In *Joe Lassiter v. United States*, the U.S. Supreme Court blocked this interpretation, ruling the plaintiff's service in Thailand did not meet the eligibility criteria for HFP.[51] Having exhausted efforts across all three branches of

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[48] Under Secretary of the Treasury, *Letter to the Under Secretary of the Air Force*, September 18, 1967.

[49] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[50] Ibid.

[51] Ibid.

government, attempts to extend the income tax exclusion to combat support operations in Thailand were abandoned. Future attempts to include support areas in combat zone designations in the Persian Gulf and the Balkans would prove more successful.

Eligibility for combat tax benefits in Southeast Asia did not conclude with American withdrawal from South Vietnam. Following the ceasefire, there were a substantial number of missing soldiers and American prisoners of war. These soldiers would continue to collect military salaries and accrue federal tax liabilities until they were returned home or declared dead. In contrast to policy in the Korean War, the Congress determined that missing soldiers and prisoners of war should not bear the burden of accumulated tax liabilities, and passed House of Representatives (H.R.) 9900 in 1972, which exempted all Prisoner of War/Missing in Action (POW/MIA) servicemembers from federal income taxation.[52] As with other "instrumental" tax benefits such as estate tax forgiveness and time provision suspensions, fairness was central to the concept of tax relief for POW/MIA soldiers.

However, for the POW/MIA tax exclusion to be operative, the law required the continued existence of the Vietnam combat zone. It was not until 1996, once the United States normalized relations with Vietnam and resolved all outstanding POW/MIA cases, that the Vietnam combat zone designation was terminated.[53] The additional two-plus decades of the designation did not confer tax exclusions upon anyone undeserving of benefits, but the delayed undesignation of Vietnam set a precedent, which was followed by the more costly continuation of combat zones in the Balkans and the Persian Gulf. In the decade following Vietnam, subsequent congressional authorizations for income tax exclusion approved specifically for military and civilian prisoners from the USS Pueblo and the American Embassy in Tehran highlighted the lack of a comprehensive tax policy for prisoners of war that operated without reference to combat zone designation.[54] Such a policy remains absent to this day.

Vietnam era struggles over benefits eligibility exposed cracks in the administrative structure established in the Korean War. Existing administrative arrangements resulted in delays in granting benefits to Vietnam and surrounding combat areas. Advocacy for broader combat zones raised the issue of extending tax exclusions to combat support areas. Reliance on a combat zone for "instrumental" benefits caused difficulties in accommodating severe risks outside designated areas and prevented the retirement of the Vietnam designation until long after combat risks had dissipated.

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[52] H.R. Rep. No. 92-825 (daily ed. February 7, 1972).

[53] Exec. Order No. 13,002, 61 Fed Reg. 24665 (May 13, 1996), *Termination of Combat Zone Designation in Vietnam and Waters Adjacent Thereto*.

[54] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

5. Current Tax Exclusion: Revising the Relationship between Risk and Reward

Recent changes to the administration of combat tax benefits have their roots in the restructuring of HFP in the 1980s. Although the HFP changes did not specifically address tax benefits themselves, the establishment of Imminent Danger Pay (IDP) in 1983 lowered the threshold for rewarding combat risks. Previously, HFP of $65 per month was authorized to those exposed to the threat of enemy fire in designated Hostile Fire areas. In response to the changing threat environment characterized by prolonged, low-intensity conflicts, the Congress proposed the creation of IDP to accompany preexisting Hostile Fire benefits. Whereas HFP covered areas of active combat, IDP extended an identical level of compensation on the basis of "the threat of physical harm or imminent danger on the basis of civil insurrection, civil war, terrorism, or wartime conditions."[55] This change, intended to benefit soldiers deployed in Lebanon, El Salvador, and Grenada, lowered the threshold for monetary benefits from *actual* hostile fire (HFP) to *the threat of* hostile fire (IDP).

Changes made to HFP were eventually incorporated into the designation criteria for combat zones. Dating back to Vietnam, the link between HFP and eligibility for combat tax benefits had already been established by T.D. 7066, enacted to benefit soldiers in Cambodia and Laos. T.D. 7066 awarded benefits to soldiers outside designated combat zones who were serving in "direct support" of combat operations and eligible for HFP. In 1991, T.D. 8489 proposed application of this preexisting standard to IDP as well.[56] For those serving in "direct support" outside combat zones, the "threat of physical harm or imminent danger on the basis of civil insurrection, civil war, terrorism, or wartime conditions" was sufficient for the same benefits as those serving within an active combat zone. The harmonization of combat tax benefits and HFP/IDP presaged lower eligibility thresholds for risk compensation in the 1990s.

At the same time, the very definition of what constituted a combat zone was changing as well. In previous conflicts, tax benefits had either been restricted to the specific area of combat operations (Vietnam and Korea) or administered without geographic limitation during complete national mobilizations (WWI and WWII). The combat zones of the 1990s broke with these precedents by designating combat support areas with limited risk potential.

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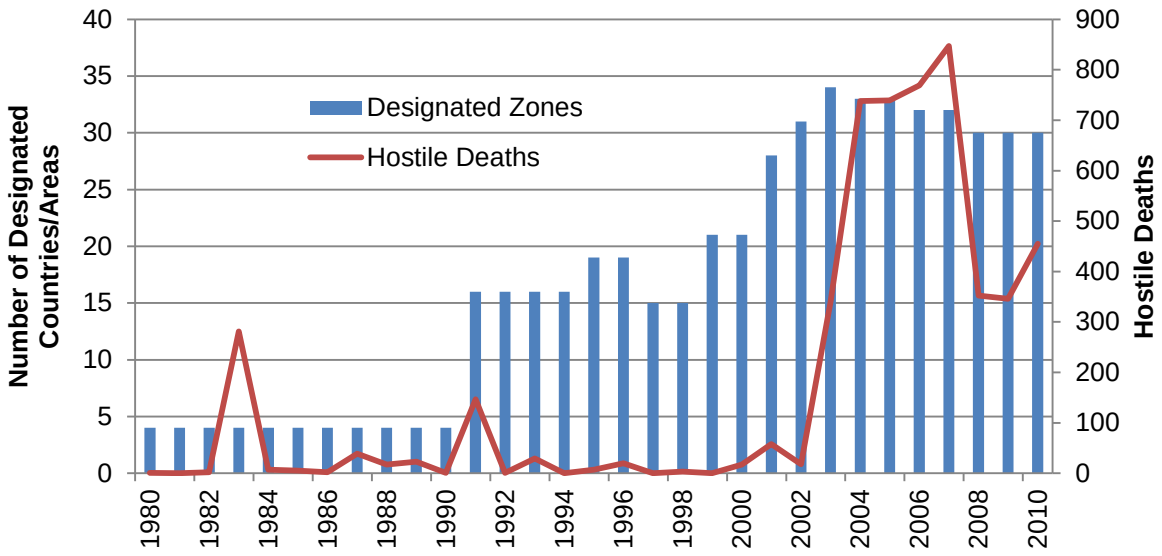
[55] Under Secretary of Defense for Personnel and Readiness, *Military Compensation Background Papers: Special Pay for Hostile Fire or Imminent Danger*, Sixth Edition, May 2005.

[56] Supplementary Information, Notice of Proposed Rulemaking, 56 Fed. Reg. 10211 (1991).

The Persian Gulf combat zone epitomized this trend. Following the passage of United Nations Resolution 678 authorizing military response to the Iraqi invasion of Kuwait, the Congress introduced legislation designating almost the entire Persian Gulf region as a combat zone under Section 112 of the Internal Revenue Code. Before passage, the legislation was preempted by E.O. 12744 to the same effect.[57] Without immediate intervention, many feared Iraqi forces would proceed beyond Kuwait into Saudi Arabia; accordingly, all three nations were designated in the Executive Order. However, E.O. 12744 did not stop there. Although few expected combat in Qatar, Bahrain, Oman, and the United Arab Emirates, all were included in the designation, as well as the waters of the Persian Gulf, the Gulf of Aden, the Gulf of Oman, the Red Sea, and parts of the Arabian Sea[58] (see Figure 4). During Desert Shield and Desert Storm, these areas hosted coalition troops preparing for deployment to Iraq or Kuwait and performing combat support operations that never experienced actual combat operations or meaningful combat risks. All the same, the tax benefits authorized for such areas were identical to those received by soldiers on the frontlines in Iraq and Kuwait. The existence of both high (Iraq, Kuwait) and very low (Qatar, Bahrain, United Arab Emirates, etc.) risk areas within the Persian Gulf combat zone diluted the correlation between risks and benefits and eroded one of the core justifications of military tax exclusions (see Figure 5). The weak relationship between risk and reward within designated combat zones continues into the 21st century. In 2007, the year of highest military casualties since the Vietnam War, over 800 servicemembers were killed, almost entirely in Iraq and Afghanistan. During this time, over 200,000 personnel throughout the theater received benefits from the CZTE, many in much safer areas outside of Iraq and Afghanistan.

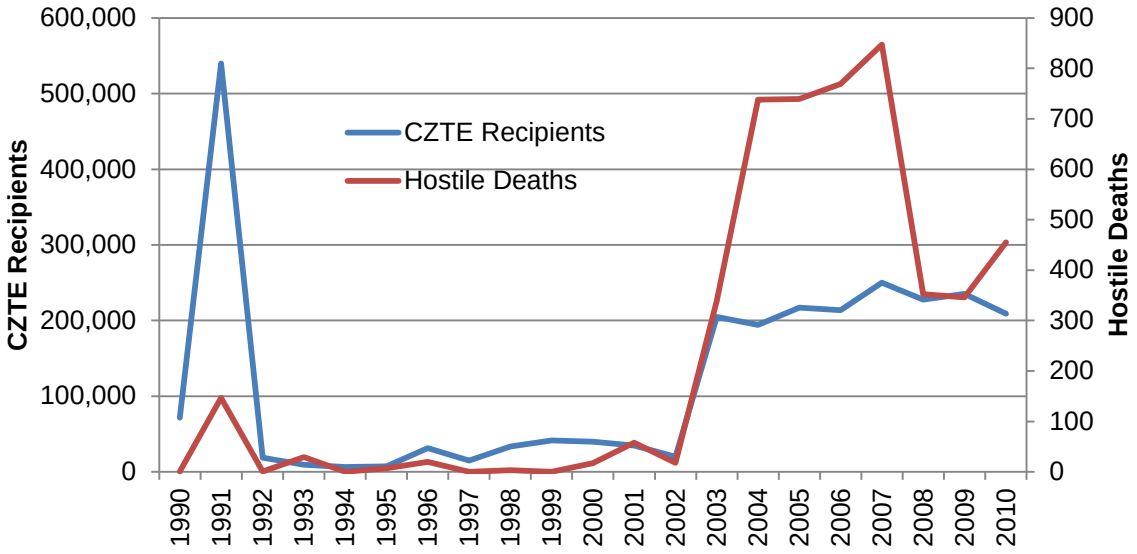
[57] Technically, E.O. No. 12744 designated the Persian Gulf states and waters as a "dangerous foreign area" not a "combat zone." The reason for this distinction was unclear, but the use of this linguistic standard echoed the authorization of IDP and its subsequent linkage to combat tax benefits through T.D. 8489. Either way, the effect of the order authorized the same benefits under Section 112 of the Internal Revenue Code.

[58] Exec. Order No. 12744 (1991), *Designation of Arabian Peninsula Areas, Airspace, and Adjacent Waters as a Combat Zone*.



Sources: DoD Statistical Information Analysis Division (SAID), Military Casualty Information, 2010; DoD Financial Management Regulation, Volume 7A, Chapter 44, August 2011.

Figure 4. Active Combat Zone Designations and Hostile Deaths (1980–2010)



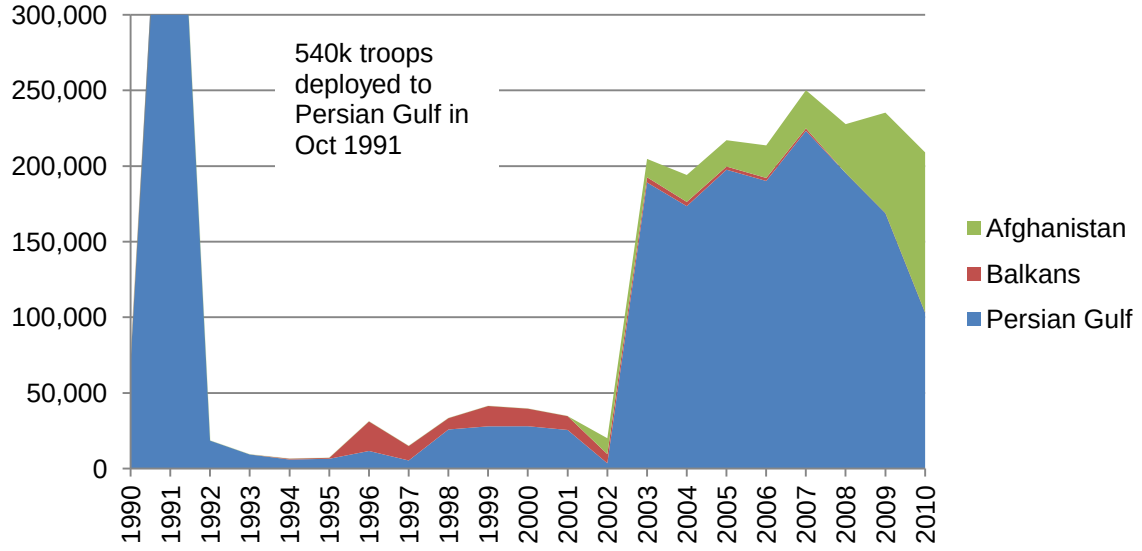
Sources: DoD SAID, Military Casualty Information, 2010; DoD SAID, Military Personnel Statistics, Historical Reports, 1953–1999, 2010; DoD SAID, Active Duty Military Personnel by Service by Region/Country, 2011.

Figure 5. Tax Exclusion Recipients and Hostile Deaths (1990–2010)

Once designated, the Persian Gulf combat zone (and the benefits therein) persisted long beyond the end of combat operations in Iraq. More than a decade later, the second Iraq War did not require a new designation because the original Persian Gulf designation remained in effect. In the period between the wars, one could argue that pilots enforcing the "No-Fly Zone," who were repeatedly targeted by Iraqi ground forces, were justified in receiving income tax

exclusions. The continued designation of Kuwait, Saudi Arabia, and the remaining land, sea, and airspace throughout the region was more tenuous from a risk perspective. In 1993, the Under Secretary of Defense for Personnel and Readiness rescinded eligibility for HFP/IDP for certain parts of the Gulf combat zone with minimal hostile risks.[59] However, in the absence of an Executive Order, members of the Armed Forces continued to receive combat zone tax benefits throughout the entire designated area, and still do today.

In Vietnam, undesignation was deferred to maintain "instrumental" benefits to those killed, captured, or missing after the war; in the Persian Gulf, no such action to preserve benefits for POW/MIA members was necessary. Regardless, undesignation was deferred—at a cost. From 1992 to 2001, an average of between 7,000 and 16,000 American troops were deployed to the combat zone, with forty-five dying from hostile actions, all unrelated to Iraqi forces (see Figure 6).[60] During this time, every deployed service member received full combat tax benefits under Section 112 of the Internal Revenue Code at cost of hundreds of millions of dollars.



Sources: DoD SAID, Military Personnel Statistics, Historical Reports, 1953–1999, 2010; DoD SAID, Active Duty Military Personnel by Service by Region/Country, 2011.

Figure 6. Deployments to Designated Combat Zones (1990–2010)

[59] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[60] An annual average of 6,917 members were stationed in the designated land areas. Including members afloat in the "North Africa, Near East, and South Asia" region, not all of which was a designated combat zone, the average is 16,547. Twenty-six deaths were attributable to friendly fire downing two Blackhawk helicopters involved in Operation Provide Comfort. Nineteen were killed in Saudi Arabia by the Khobar Towers terrorist bombing. Department of Defense Statistical Information Analysis Division, *Military Personnel Statistics, Historical Reports 1953–1999*, 2010, http://siadapp.dmdc.osd.mil/personnel/MILITARY/history/309hist.htm; *Military Casualty Information*, 2010, http://siadapp.dmdc.osd.mil/personnel/CASUALTY/castop.htm.

While administrative inaction prolonged combat designations in the Persian Gulf, inaction prevented the extension of certain tax benefits to areas of real risk. The absence of "instrumental" tax benefits for military peacekeepers in Somalia demonstrated the administrative inflexibility of tax benefits in response to fast-moving, low-intensity conflicts. Although initially opposed to Operation Restore Hope, the Senate backed extension of the CZTE to troops deployed to Somalia. Advanced by Senator Hank Brown, the chamber passed a "sense of the Senate" resolution favoring tax benefits "to recognize the men and women who serve our country in this troubled part of the world."[61] Echoing Senate sentiment, Secretary of Defense Les Aspin and Joint Chiefs of Staff Chairman John Shalikashvili urged designation of Somalia under Section 112 of the Internal Revenue Code.[62] Despite widespread support, neither the House nor President Clinton took the necessary steps to extend benefits, and the issue dropped following U.S. withdrawal. If not for the example of the Persian Gulf combat zone, the absence of a designation for Somalia may have been understandable. In the past, the Treasury Department had been skeptical of eligibility for "combat-type activities falling short of open warfare," as in Somalia.[63] However, given eligibility for low-risk combat support areas such as Qatar and Bahrain the denial of benefits in Somalia seems an error of omission. That the 1,154 soldiers in Bahrain and Saudi Arabia received tax exclusions in 1994—yet the 933 troops in Somalia did not—demonstrates that the administrative process produced inconsistent results.[64] Even if the omission were a conscious decision on behalf of the White House, the need for a designated combat zone to extend "instrumental" benefits prevented posthumous income tax forgiveness to the 43 soldiers dying in Operation Restore Hope—a clear inequity.

Following Somalia, the Congress was determined not to cede the initiative on tax benefits to the Clinton administration. When U.S. troops were deployed to the former Yugoslavia to enforce the Dayton Accords, the Internal Revenue Service granted automatic time extensions for income tax filing to soldiers in the Balkans, but an Executive Order was not forthcoming from the president.[65] With the specter of Somalia hovering in the background, the House introduced H.R. 2776, Tax Benefits for Individuals Performing Services in Certain Hazardous Duty Areas, an action which Representative Jim Bunning (R-KY) justified by saying:

> Quite frankly, we must act to insure [*sic*] that we do not have a repeat of what happened in Somalia. In Somalia, the families of the soldiers who lost their lives could not receive the benefits that should have gone to them under the Tax Code because the President never declared it a combat zone…Unfortunately, the peacekeeping operations in the former Yugoslavia have not been designated by

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[61] 139th Cong. Rec. S13588 (daily ed. October 18, 1993).

[62] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

[63] Under Secretary of the Treasury, *Letter to the Under Secretary of the Air Force*, September 18, 1967.

[64] DoD Statistical Information Analysis Division, *Military Personnel Statistics: Active Duty Military Personnel by Service by Region/Country*, Historical Reports, 2011.

[65] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.*

> the President as being in a combat zone…our service personnel are in a combat zone type situation even if the President has not declared it a combat zone.[66]

H.R. 2776 designated the land and airspace of Bosnia and Herzegovina, Croatia, and Macedonia as a Qualified Hazardous Duty Area (QHDA). Section 112 of the Internal Revenue Code provided the same tax benefits for servicemembers present within the QHDA as for those deployed to a designated combat zone. These benefits would continue as long as servicemembers within the QHDA were eligible to receive HFP or IDP, but terminate thereafter. The Congress also took care to ensure that all "instrumental" tax benefits, excerpted from a House Report below, would be extended to members serving in the former Yugoslavia:

> (1) Section 2(a)(3) (relating to special rule where deceased spouse was in missing status).
>
> (2) Section 112 (relating to the exclusion of certain combat pay of members of the Armed Forces).
>
> (3) Section 692 (relating to income taxes of members of Armed Forces on death).
>
> (4) Section 2201 (relating to members of the Armed Forces dying in combat zone or by reason of combat-zone incurred wounds, etc.).
>
> (5) Section 340(a)(1) (defining wages relating to combat pay for members of the Armed Forces).
>
> (6) Section 4253(d) (relating to the taxation of phone service originating from a combat zone from members of the Armed Forces).
>
> (7) Section 6013(f)(1) (relating to joint return where individual is in missing status).
>
> (8) Section 7508 (relating to time performing certain acts postponed by reason of service in combat zone).[67]

Linkage between tax benefits and HFP/IDP added the potential for greater flexibility for the administration of tax benefits under the QHDA. Historically, HFP/IDP has proved easier to manipulate in response to changing risk environments than combat zone designations. It was thought that linkage to HFP/IDP would remedy difficulties in withdrawing income exclusions when circumstances no longer justified tax benefits, but this flexibility was not realized. Rather than HFP/IDP contributing to the flexibility of the CZTE, the reverse has occurred: the existence of combat tax benefits has made it more difficult to withdraw HFP/IDP in the Balkans. Although the Congress had feared military peacekeepers would be placed in the line of fire, combat risks in the Balkans never materialized. Between 1994 and 2004, twenty servicemembers died in Operation Joint Endeavor with only a single combat fatality. Notwithstanding the absence of anticipated risks, both HFP/IDP and combat tax benefits remained available until November

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[66] 142nd Cong. Rec. H1670 (daily ed. Mar. 5, 1996).

[67] Ibid.

2007, when Bosnia, Serbia, and Macedonia lost Imminent Danger Area status.[68] However, even the termination of HFP/IDP for Balkan nations may not prove sufficient to curtail tax benefits for soldiers deployed to the QHDA. Due to a statutory quirk, eligibility for HFP/IDP arising from isolated hostile incidents may reactivate combat tax benefits for the entire QHDA.[69] Thus far, the language of the QHDA authorization has not been tested in this respect.

As the distribution of risk within designated combat zones has widened, the distribution of tax benefits has shifted. As a result, the monetary value of today's tax benefits is highly concentrated among higher income earners, including field grade officers. Changes to the distribution of benefits are not without historical precedent. In addition to legislative revisions—such as the 1945, 1950, and 1966 updates—external changes in overall military pay and the federal tax code alter the distribution of benefits. Sometimes external changes, such as the enlisted pay raises of the late 1940s, have benefited lower ranking members; in other instances, like the Reagan income tax cuts of the 1980s, officers have received greater benefits.

In contrast to these routine disturbances, a legislative change in 1996 created permanent, and perhaps unintended, shift in the officer-enlisted distribution of tax benefits. Since 1945, all combat zone compensation for enlisted members and a portion of officer pay has been excluded from federal income tax. Prior to 1996, the officer exclusion was set by law at a fixed amount, which required periodic revision to keep pace with inflation—$1,500 per year from 1943 to 1950, $200 per month from 1950 to 1966, and $500 per month thereafter. These amounts were intended to correspond with a given level of pay for enlisted members. By the 1990s, a quarter century after the last update, the Congress determined that the time for revision was at hand. In 1990, Senator John Glenn (D-OH) introduced legislation (Senate Resolution 3025) to grant tax benefits to members serving in Operation Desert Shield. Included in S. 3025 was a raise to the maximum officer income tax exclusion to $2,000 per month under Section 112 of the Internal Revenue Code.[70] At this level, the traditional level of parity between senior enlisted and commissioned officer benefits would be restored (see Figure 7). The House scheduled hearings on a similar bill, but before a vote could be held, President Bush designated the Persian Gulf region, halting the legislative process. Throughout the Persian Gulf War, the Congress made no update to the officer tax exclusion.

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[68] HFP/IDP and combat tax benefits remain available under the QHDA within the breakaway state of Kosovo.

[69] Kusiak, *Exclusion from Gross Income during War or in Combat Zones.* Entitlement to HFP is achieved through meeting one of two criteria: (1) presence within a designated Hostile Fire Area or (2) unit exposure to injury or death from hostile fire outside a designated area. As of November 2007, the QHDA (excepting Kosovo) is ineligible for the first of these two standards. However, members deployed in the QHDA may still receive HFP based upon the second of these criteria. Even if exposure to hostile fire is unrelated to the QHDA itself, the Kusiak study suggests that eligibility for HFP from isolated events within the QHDA may reinstate entitlement to combat zone tax benefits to all servicemembers in the QHDA.

[70] S. Rep. No. 101-3025 (daily ed. September 11, 1990).

LEGEND
Pays no income tax
Receives full $2,000 exclusion

Enlisted Rank	Min	Max	Officer Rank	Min	Max
SgtMaj (E9)	$2171	$2796	Col (O6)	$2925	$5053
MstrSgt (E8)	$1821	$2497	LtCol (O5)	$2339	$4123
SFC (E7)	$1271	$2447	Maj (O4)	$1972	$3447
SSgt (E6)	$1094	$1640	Capt (O3)	$1832	$2981
Sgt (E5)	$960	$1392	1st Lt (O2)	$1598	$2212
Corp (E4)	$896	$1121	2nd Lt (O1)	$1387	$1745

Source: DFAS, Military Pay Tables, 1990.

Figure 7. Military Monthly Pay – Proposed Combat Income Exclusions and Pay Grades in 1990

In the Balkans, the Congress was far more proactive. Eager not to repeat the Somalia experience, the Congress quickly enacted H.R. 2778, designating the former Yugoslavia as a QHDA for federal tax purposes. An amendment to H.R. 2778 offered by Ways and Means Chairman Bill Archer (R-TX) and Ranking Member Sam Gibbons (D-FL) revised the maximum officer exclusion, not to $2,000 per month, as proposed in 1990–91, but to the "maximum enlisted amount."[71] This appeared to solve two problems: in theory, the revision restored the historical parity between senior enlisted and commissioned officer exclusions, and it prevented the need for future revisions to keep pace with military pay levels and inflation. In the Congressional Record, Representative Floyd Spence (R-SC) confirmed the intent of the change:

> We on the Committee on National Security have been working since the Persian Gulf War to update the $500 cap on officer exemptions in current law. The $500 cap dates back to 1966 and has long since lost any relevance to officer income levels. HR 2778 not only restores the value of this benefit for officers, it precludes this problem from reoccurring by linking the cap to the maximum pay for an enlisted person.[72]

However, the phrase "maximum enlisted amount" more than restored officer exclusions to their previous levels. Updates in 1943, 1950, and 1966 had set officer exclusions roughly on par with basic pay for the highest ranking enlisted member (Sergeant Major, E-9)[73] with the minimum years of service for the grade (usually 10). The proposal for a $2,000 monthly exclusion in 1990 was consistent with this standard of parity (an E-9 with 10 years of service received $2,171.70 per month in 1990) (see Figure 7). If the tradition were to be continued in 1996, the officer exclusion would have been around $2,600 per month (E-9, 10 Years of Service (YOS) received $2,623.20). With maximal (over 26) years of service, an E-9 earned $3,377.10. However, because the six most senior enlisted personnel in the military earned $4,109.56 per

[71] H.R. Rep. No. 104-465 (daily ed. Feb. 29, 1996).

[72] 142nd Cong. Rec. H1670 (daily ed. Mar. 5, 1996).

[73] The highest rank for enlisted members in 1943, 1945, and 1950 was E-7 (Sergeant First Class).

month, that value determined the level of authorized exclusion for all officers. This is 56 percent higher than the previously accepted standard.

Under the historical standard of parity most officers higher than O-3 paid some income tax; under the new standard almost all officers below the grade of O-5 were exempted from paying income taxes (see Figure 8).[74] Those that did pay tax on some of their military compensation still received far more generous benefits than had been historically available.

LEGEND
Pays no income tax
Receives full $4,104.90 exclusion

Enlisted Rank	Min	Max	Officer Rank	Min	Max
SgtMaj (E9)	**$2623**	$3377	Col (O6)	$3533	$6103
MstrSgt (E8)	$2200	$3016	LtCol (O5)	$2825	$4979
SFC (E7)	$1536	$2714	Maj (O4)	$2381	$4163
SSgt (E6)	$1321	$1981	Capt (O3)	$2213	$3601
Sgt (E5)	$1160	$1681	1st Lt (O2)	$1930	$2672
Corp (E4)	$1081	$1354	2nd Lt (O1)	$1676	$2108

Source: DFAS, Military Pay Tables, 1996.

Figure 8. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1996

Officers with higher military compensation benefited from the larger exclusion in other ways as well. Because combat zone compensation was not considered "earned income," many officers receiving the $4,104.90 exclusion paid lower marginal taxes on income above the exclusion. In many cases, if officers received a full exclusion but still had a small adjusted gross income for tax purposes, they could receive an Earned Income Tax Credit (EIC) intended as an antipoverty measure for the general populace.[75] In light of this reversal, it bears repeating that the purpose of capping officer exclusions in WWII and thereafter was to establish a level of parity between enlisted members and commissioned officers. The revision of officer exclusions to the "maximum enlisted amount" altered the distribution of benefits such that high-income officers received greater benefits per person relative to enlisted members from income tax exclusion than had previously been the case.

[74] O-4s, 18 YOS and O-6s, 3 YOS had liabilities less than $50 per month. O-5s with more than 14 YOS had slightly larger liabilities, but always under $1,000 per month. This assumes no other income exclusions. When other exclusions (personal, dependents, health insurance, retirement savings, mortgage interest, etc.) are taken into account, even fewer had tax liabilities. Additionally, O-5s with less than 16 YOS and O-6s with less than 14 YOS had no tax liability after the CZTE. There are very few officers at these levels with these YOS.

[75] At the time, enlisted members (and junior officers) were not eligible for EIC because they reported no earned income. Responding to complaints from the lower ranks, the Congress subsequently (in 2005) authorized all enlisted and junior officers in combat zones to receive an EIC benefit, rather than strip eligibility from more senior (and certainly not impoverished) officers.

In summary, designated combat zones now include the full spectrum of risk from widespread mortal danger in Iraq or Afghanistan to everyday normality in Qatar, Bahrain, or (potentially) the Balkans. The administrative apparatus still struggles to designate combat zones and confer “instrumental” benefits where appropriate, as in Somalia, and has difficulty retracting designations when no longer justified (the Persian Gulf and the Balkans). At the same time, revision of the maximum officer exclusion to the “maximum enlisted amount” has shifted the benefits toward commissioned officers. Under today’s exclusion, an O-6 deployed to Bahrain receives almost quadruple the tax benefits of an E-3 serving in Baghdad. Note also that a service member dying from hostile fire outside a designated combat zone receives no benefits and must pay tax on any outstanding income or estate liabilities.

Illustrations

Figures

Figure 1. Military Annual Pay – Combat Income Exclusions and Pay Grades in 1943 and 1945 10
Figure 2. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1950 12
Figure 3. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1966 16
Figure 4. Active Combat Zone Designations and Hostile Deaths (1980–2010) 23
Figure 5. Tax Exclusion Recipients and Hostile Deaths (1990–2010) 23
Figure 6. Deployments to Designated Combat Zones (1990–2010) 24
Figure 7. Military Monthly Pay – Proposed Combat Income Exclusions and Pay Grades in 1990 28
Figure 8. Military Monthly Pay – Combat Income Exclusions and Pay Grades in 1996 29

References

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Abbreviations

CZTE	Combat Zone Tax Exclusion
E.O.	Executive Order
EITC	Earned Income Tax Credit
H.R.	House of Representatives
HFP/IDP	Hostile Fire Pay/Imminent Danger Pay
HFP	Hostile Fire Pay
IDP	Imminent Danger Pay
MIA	Missing in Action
POW	Prisoner of War
QHDA	Qualified Hazardous Duty Area
S.	Senate
T.D.	Treasury Directive
U.S.	United States
WW	World War
YOS	Years of Service

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14. ABSTRACT
Exclusion of military pay from federal income taxes has been a long-standing element of U.S. policy on war finance, combat compensation, and revenue collection in combat zones. This paper describes its evolution over time. The Combat Zone Tax Exclusion (CZTE) was originally established to alleviate the burden of war finance from those who fought in the nation's conflicts. During World War (WW)II, combat tax benefits were separated from war finance policy and became an entrenched component of combat compensation. Over time, administrative inefficiency and changes to the tax code have further eroded the tax exclusion's traditional purpose, while generating an unintended inequitable distribution of benefits. At present, the CZTE neither serves its original purpose of exempting servicemembers from the burden of war finance nor its later historical role of selectively rewarding those who face a high level of combat risk.

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