



## Disabled American Veterans Transition Service Office

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### **INCOME TAX FILING AND DEPARTMENT OF VETERANS AFFAIRS DISABILITY COMPENSATION**

Normally, a few months elapse between the effective date of a Department of Veterans Affairs, (DVA), disability rating decision and the waiver of retired military retired pay required under, “concurrent receipt.” Military retirees should reduce taxable military retired pay, as indicated on Form 10-99-R, by the dollar amount of the DVA disability compensation that would have been payable had the military retiree been accurately paid for the affected period. This is a very important step in taking advantage of the government’s intended tax savings benefit for veterans in retired military status. Cite 38 U.S. Code, Section 5301 and IRS Ruling 78-161, as the authority. This guidance may also be used for retroactive receipt of a DVA disability rating, or a retroactive increase in such a rating. Since no statute of limitations is addressed for such veterans’ tax relief, the three-year statute of limitations found in 26 U.S. Code, Section 6511(d) applies.

What follows is the, 19 April 2002, verbatim guidance from Ms. Crystal Reimann, IRS Senior Tax Specialist.

“In these situations, the IRS needs to know exactly who paid you and when the Department of Veterans Affairs, (VA) made the determination that you were disabled. In addition, when the VA determined you were disabled, was the decision retroactive? If so, back to when? If the VA retroactively determined you to be disabled, did you waive an equal amount of retirement pay you might receive from the VA? Such VA benefits are excluded from gross income for the taxable year the waiver is filed and succeeding years. VA benefits are not excluded from gross income for years before the waiver is filed. You may file claims for refund of taxes paid on the retroactive amounts for prior years, back to the earliest year not barred by the statute of limitations that the waiver was on file. A copy of VA Form 20-8993 or an official VA letter granting the retroactive benefit and clearly stating in lieu of VA Form 20-8993 must be attached to the claim. If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, do not include in your income the portion of the severance payment equal to the VA benefit you would have been entitled to receive in that same year. However, you must include in your income any lump-sum readjustment or other non-disability severance payment you received on release from active duty. See Publication 525, page 14 and Internal Revenue Manual 21.6.6.4.21. If all this happened in 2001, report the full lump-sum severance payment showing on Form 1099-R on lines 16a and 16b of Form 1040. On line 21, put the non-taxable portion in parentheses and note on the dotted line Retroactive VA adjustment. When you are adding the income lines on Form 1040 to determine the total income to enter on line 22, subtract the amount in parentheses on line 21. Enter your withholding on line 59. Once again, a copy of VA Form 20-8993 or an official VA letter granting the retroactive benefit and clearly stating in lieu of VA Form 20-8993 must be attached to the claim.

*Building Better Lives For America’s Disabled Veterans And Their Families*

**The following is Rev. Rule. 78-161.** Armed Forces retirement pay; retroactive disability determination. The Service will follow the Strickland decision as precedent in holding that a taxpayer, who retired from a branch of the Armed Forces in 1976 for years of service and subsequently was awarded a retroactive service connected disability rating by the VA, may exclude from gross income under section 104(a)(4) of the Code that portion of the retirement pay received from the branch of the Armed Forces during the retroactive period that corresponds to the amount attributable to the VA disability rating; Rev. Rule. 62-14 revoked.

Its full text is stated later. Also released as News Release IR-1979, dated March 31, 1978. Section 104. - Compensation for Injuries or Sickness. 26 CFR 1.104-1: Compensation for injuries or sickness. 1978-1 C.B. 31; 1978 IRB. Rev. Rule. 78-161. January 1978. Advice has been requested whether, under the circumstances described below, a taxpayer may by reason of a retroactive disability compensation determination by the VA, exclude from gross income under section 104(a)(4) of the Internal Revenue Code of 1954, any portion of the payments made to the taxpayer during the retroactive period by a branch of the Armed Forces as retirement pay based on years of service.

The taxpayer retired from the United States Army on January 1, 1976, for years of service and began receiving retirement pay. On February 15, 1976, the taxpayer applied to the VA for service connected disability benefits and was awarded, on December 1, 1976, a 90 percent disability rating retroactive to February 28, 1976. In order to receive actual payment of the benefits the taxpayer filed, on December 15, 1976, a waiver, pursuant to section 1005 of the Veterans Benefits Act of 1957, 38 U.S.C. 3105 for reduction of the taxpayer's retirement pay in an amount equal to the disability compensation benefits. Effective from the date of the waiver the taxpayer began receiving disability compensation from the VA and reduced retirement pay from the Army.

Section 61(a) of the Code provides that unless otherwise excluded by law, gross income means all income from whatever source derived, including compensation for services.

Section 104(a)(4) of the Code and the regulations there under provide, with certain exceptions not pertinent to this case, that gross income does not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country.

Section 3010(a) of title 38 U.S.C. provides, in part, that payments due or to become due under any law administered by the VA shall be exempt from taxation.

Rev. Rule. 62-14, 1962-1 C.B. 11, holds, in part, that when a taxpayer is awarded disability compensation by the VA, no portion of the regular Army retirement pay based on years of service previously received is excludable from gross income even though the effective date of the award is made retroactive.

In *Strickland v. Commissioner*, 540 F.2d 1196 (4th Cir. 1976), the taxpayer retired from the Army for length of service and began receiving retirement pay. Subsequently, the taxpayer applied to the VA for service connected disability benefits and was awarded a 10 percent disability rating. In order to receive actual payment of the benefits the taxpayer filed the required VA form on March 10, 1965, waiving that portion of Army retirement pay equal to the amount of the VA disability benefits. In March 1966 the taxpayer filed a second claim with the

VA requesting an increase in disability benefits. On January 17, 1967, the VA notified the taxpayer that the taxpayer was awarded a 100 percent disability rating, as of March 28, 1966, entitling the taxpayer to an additional \$208 per month disability benefits. The VA commenced this benefit on February 1, 1967, after the Army notified the VA that it would correspondingly reduce the taxpayer's retirement pay. The court held that the VA's retroactive determination that the taxpayer was eligible for increased disability benefits was controlling. Thus, the taxpayer was entitled to exclude from gross income under section 104(a)(4) of the Code, part of the payments previously received as retirement pay based on rank and length of service.

The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Fourth Circuit in Strickland as precedent in the disposition of similar cases involving section 104(a)(4) of the Code.

Accordingly, in the instant case, the taxpayer may exclude from gross income under section 104(a)(4) of the Code, that portion of the taxpayer's Army retirement pay received between March 1, 1976 and December 15, 1976, that corresponds to the amount attributable to the VA disability rating. Rev. Rule. 62-14 is revoked."

What follows is the, 24 April 2002, "easy read," guidance from Ms. Crystal Reimann, IRS Senior Tax Specialist. She suggests it be provided to tax preparation services and disabled veterans who are not up on the latest, "how to," guidance regarding this subject.

## **Non-Taxable Veterans Administration Benefits** **"Easy Read"**

The following Internal Revenue Code Sections, Revenue Rulings and Court cases allow for the exclusion of select Veterans Benefits from taxable income, they include:

Internal Revenue Code Section 104(a) (4) exempts from income pension, annuity, or similar payments for personal injuries or sickness that resulted from combat-related service. In addition, Disability retirement pay that is computed on the basis of the percentage of disability is fully excludable from gross income, but disability retirement pay that is computed by reference to years of service is excludable only to the extent allowed under the percentage-of-disability method.

Revenue Ruling 91-14 states that dividends and proceeds from government endowment insurance contracts under the National Service Life Insurance Act of 1940 and all other acts relating to veterans are exempt from income tax.

The 38 USC Section 5301 et seq. states that Veteran's benefits under any law administered by the Veterans Administration are not includible in income. This includes amounts paid to veterans or their families in the form of education, training, subsistence allowances, disability compensation, and pension payments for disabilities, grants for homes designed for wheelchair living, grants for motor vehicles for veterans who lost their sight or the use of their limbs, and veterans pensions.

These items are excluded from income on line 16 b of form 1040, or line 12b of form 1040A. To compute the non-taxable portion you take the full pension received and subtract the non-taxable payments. The balance is then reported on line 16b of the form 1040, or line 12b form 1040A.

If these non-taxable payments were included into income by accident, the tax form needs to be corrected using form 1040X.