

**APPEALS**  
**SETTLEMENT GUIDELINES**

**ISSUE:** Military Disability Retirement Benefits

**TECHNICAL SPECIALIST:** Jack Ellis

**TELEPHONE:** (216) 623-2002

**UIL NO:** 104.04-00, 122.01-00

**FACTUAL/LEGAL ISSUE:** Factual and Legal

**The attached document has been approved as the Appeals Settlement Guidelines and is effective from the date shown below until withdrawn or superseded by subsequent Appeals Settlement Guidelines.**

**APPROVED:**

*/s/ Reinhard Schmuck*

12-19-2012

---

Reinhard Schmuck  
Director, Domestic Operations

---

DATE

***Kirsten B. Wielobob***

12-19-2012

---

Kirsten B. Wielobob  
Director, Specialty Operations

---

DATE

**EFFECTIVE DATE: December 19, 2012**

# **APPEALS SETTLEMENT GUIDELINES**

## **Military Disability Retirement Benefits**

### **STATEMENT OF ISSUES**

- a. Retroactive U.S. Department of Veteran's Affairs (VA) determination – I.R.C. § 104:  
May a taxpayer reduce the taxable military retirement income amount reported on the Form 1099-R (increasing his or her nontaxable disability income under I.R.C. § 104) when receiving a retroactive VA disability determination?
- b. Net Disability Exclusion – Treas. Reg. § 1.122-1:  
What is a proper calculation of the nontaxable disability income based on the formula found in Treas. Reg. §1.122-1(d), Example 4 when a VA disability determination has been made?

### **COMPLIANCE POSITION**

Since the U.S. Department of Defense (DOD) has all the information needed to determine the proper taxable income, Compliance's position is the Form 1099-R issued to the Taxpayer by the DOD is correct and the taxpayer should not reduce his or her military retirement income upon receiving a retroactive VA disability determination. Where a correction is needed to the 1099-R, the taxpayer must address his or her concern with the DOD. There is one limited exception - an increase to a taxpayer's nontaxable disability income is possible if the taxpayer is able to present a bona fide retroactive VA Determination Letter.

### **TAXPAYER POSITION**

Taxpayers claim they are entitled to additional nontaxable disability income based on a formula found in Treas. Reg. § 1.122-1(d), Example 4.

Some taxpayers have followed an opinion offered by a representative while others have found the information on internet blogs. These taxpayers have obtained a worksheet that calculates nontaxable disability income based on Treas. Reg. § 1.122-1(d), Example 4.

### **DISCUSSION**

#### **Background**

The DOD is responsible for reporting a military retiree's taxable pension benefits on Form 1099-R. If a retiree was discharged for medical reasons for job-related injuries while on active duty, then the DOD has provided a disability evaluation.

The VA is a separate governmental department from the DOD. The VA evaluates all military retirees that claim diminished physical or mental capacity and provides a “VA Disability Rating.” Some individuals will get two evaluations – one from the DOD and one from the VA. Others will only have a VA evaluation.

The VA approves retirees for medical benefits by providing them a disability percentage. A retiree can have a stated monthly amount representing the disability percentage converted to nontaxable income by signing a waiver. Once the waiver is signed, the VA will pay the retiree the stated monthly amount directly and the DOD will reduce its taxable retirement payment to the taxpayer by the same amount (called the “VA compensation deduction”). The DOD will not include the amount of the VA payment on the Form 1099-R. The VA does not report the payments it makes on a Form 1099-R.

There are two general scenarios that describe a military retiree’s situation when claiming a disability:

1. The retiree receives a military disability retirement and a VA disability award determination or
2. The retiree receives a normal (years and age) retirement and a VA disability award determination.

The accuracy of the DOD’s Form 1099-R is dependent on a final VA disability determination made prior to issuance of the Form 1099-R. The VA can take anywhere from several months to years to determine the final disability percentage rating for the retiree, and, often, the VA makes its determination retroactively. If months or years go by, the DOD will have reported taxable income without the benefit of the VA disability award to calculate the nontaxable disability income. The only re-computation of previously reported military taxable income that is potentially available to taxpayers will be based upon the retroactive disability determination by the VA.

## **Legal Analysis**

### **I.R.C. § 104**

Military disability payments are nontaxable income pursuant to I.R.C. § 104. I.R.C. § 104(a)(4) states 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...” Pursuant to I.R.C. § 104(b)(1), I.R.C. § 104(a)(4) applies to individuals who are evaluated as disabled by either the DOD or the VA. In general, the only situation in which a military retiree can claim additional nontaxable income retirement pay is when the VA makes a retroactive disability determination after the start of retirement.

As described earlier, a military retiree may file a disability claim with the VA and receive a nontaxable VA payment. In Strickland v. Commissioner, 540 F.2d 1196, (4<sup>th</sup> Cir. 1976), the Court determined that the VA's disability determination created a payment under I.R.C. § 104. Section 104 provides for income exclusion of pension, annuity or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country. The Court held that the taxpayer, who retired from a branch of the Armed Forces in 1964 after years of service and subsequently was awarded a retroactive service-connected disability rating by the VA, may exclude from gross income under I.R.C. § 104(a)(4), that portion of the disability retirement pay received. The taxpayer was allowed a refund for the recalculated taxable income back to the date the claim for the disability rating was filed with the VA. In Rev. Rul. 78-161, 1978-1 C.B. 31, the IRS acquiesced to the Strickland case.

In Holt v. Commissioner, 78 T.C.M. (CCH) 625 (1999), the taxpayer was denied the additional disability income reduction because the income attributable to the VA percentage of disability determination and the petitioner's subsequent election had already been excluded from the petitioner's income by the Defense Finance and Accounting Service on Form 1099-R. The Court further stated that Rev. Rul. 78-161 did not apply since there was not a retroactive VA determination.

After a taxpayer's military retirement, the VA determines a disability amount. Since the DOD previously provided a Form 1099-R, the DOD has no mechanism to allow the retiree credit for the nontaxable income back to the date the application to VA was filed. Rather, a taxpayer must claim a refund of tax paid on the excludable amount (subject to the statute of limitations) by filing a Form 1040-X, Amended U.S. Individual Income Tax Return, for each previous year during the retroactive period.

### **I.R.C. § 6511**

I.R.C. §6511 (a) provides that a claim for a tax refund must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever is later. Congress, recognizing that injustice could arise when veterans were awarded retroactive changes to the tax status of their income, modified this statute of limitations by adding § 6511(d)(8). This law change extended the statute of limitations by a one year period beginning on the date of the determination of disability. The one year extended period applies to claims for credit or refund filed after June 17, 2008 and does not apply to any tax year that began more than five years before the date of the determination. I.R.C. § 6511(d)(8)(B).

### **Treas. Reg. § 1.122-1(d)**

Treas. Reg. § 1.122-1(d), Example 4 addresses a taxpayer that receives a DOD disability retirement due to "service-related injuries" and has a VA determination of disability. Under the tax law, after proper elections are made, the DOD will have the appropriate information and will provide the "net disability exclusion". The taxpayer has no authority to request this computation from the Internal Revenue Service.

Example – Treas. Reg. § 1.122-1(d), Example 4 calculation:

B, a member of the uniformed services, retires on January 1, 1966, after 32 years of active military service, and receives disability retirement pay under section 1401 of title 10, limited to 75 percent of his active duty pay of \$15,000 per year, or \$11,250. His disability rating is 30 percent. B has not reached retirement age (as defined in § 1.79–2(b)(3)). He elects under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) to provide his survivor with an annuity equal to one-half of his reduced retired pay and, for that purpose, his retired pay of \$11,250 is reduced by \$1,250 to provide an annuity of \$5,000 per year. B also elects to waive retired pay in the amount of \$1,000 in order to receive disability compensation in like amount under laws administered by the Veterans Administration.

Gross Active Duty Pay	\$15,000
Retirement pay limited to 75% of active duty pay	11,250
Section 122(a) exclusion for Survivor Annuity	<u>(1,250)</u>
Reduced retired pay	10,000
Less: Retired pay waived by TP to receive VA compensation	<u>(1,000)</u>
Adjusted retired pay	9,000
Less: Net disability exclusion (= (i) – (ii))	
(i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403 (30% of 15,000 or active duty pay)	\$4,500
(ii) Less: Retired pay, not to exceed (i), waived to receive VA compensation	<u>(1,000)</u>
Net disability exclusion	<u>(3,500)</u>
Taxable retired pay	<u>5,500</u>

Example 4 applies the special rules set forth in Treas. Reg. §1.122-1(c) to reduce the \$10,000 taxable retirement by the excludable disability amounts. Applying the hierarchy of rules set out in the Regulation, the military retiree is allowed the VA disability determination (compensation) immediately in the calculation. Where the DOD has made a determination that there is no disability, the computation for taxable retired pay would stop (\$9,000 in example above). The second part of the formula is to determine whether the taxpayer has additional disability payments beyond the VA determination. Treas. Reg. §1.122-1(d), Example 4 highlights an additional fact where the DOD determines the injury to be a service related disability. Following Treas. Reg. §1.122-1(c), the amount of excludable retirement pay would be further reduced by the amount of the DOD disability determination as adjusted for amounts previously excluded as VA disability benefits.

Example 4 applies in those instances where a retroactive disability determination has been made by the VA which was not previously incorporated in the 1099-R reported taxable retired pay. In most instances, the amounts reported on the 1099-R should already reflect an adjustment for the VA disability exclusion.

### **Appeals Analysis**

In the Appeals cases received, taxpayers are requesting additional nontaxable disability income based on a literal application of Treas. Reg. 1.122-1(d) Example 4. Two items have been noted on Appeals cases with these issues:

1. Taxpayers exclude the VA disability benefit twice from taxable military retirement income; and
2. The DOD had not made a disability determination. Therefore, taxpayers lack comparable facts to Treas. Reg. 1.122-1(d) Example 4 to compute the excludable portion of disability retirement pay.

Holt v. Commissioner, 78 T.C.M. (CCH) 625 (1999) is directly on point to the issues before Appeals.

### **SETTLEMENT GUIDELINES**

a. Retroactive VA determination – I.R.C. § 104: Under limited circumstances, a taxpayer may reduce taxable military retirement income reported on Form 1099-R (increasing nontaxable disability income under I.R.C. § 104) when he or she receives a retroactive VA disability determination. Publication 525 on Taxable and Nontaxable Income states a copy of the official retroactive VA Determination letter and effective date must be either attached to the claim (Form 1040-X) or otherwise provided. The VA Determination letter must include the table containing the headings - "Amount Withheld" and "Payment Start Date" or "Effective Date" to compute the nontaxable component, if any.

If a retroactive VA disability determination is present and the DOD did not incorporate the VA disability payment into the calculation, the Service must apply the VA monthly payment to each month within the retroactive period.

b. Net Disability Exclusion – Treas. Reg. § 1.122-1: Taxpayers should not recalculate additional nontaxable disability income on the basis of this regulation unless the facts are right on point with the facts in Treas. Reg. § 1.122-1(d). Any claim citing Treas. Reg. § 1.122-1 will not be sustained unless the taxpayer's facts are identical to the example.

I.R.C. § 122 requires the military retiree to elect the reduction of pay for certain family and survivor benefits. Treas. Reg. § 1.122-1(d), Example 4 ensures that a taxpayer will deduct the VA determination plus any net disability exclusion. The exclusion is the amount of DOD disability retirement income in excess of the VA disability compensation. The VA evaluates all military retirees that claim diminished physical or

mental capacity while in uniform and provides a VA disability rating. The DOD provides a second disability rating for soldiers that must be medically discharged due to injuries received on the job which is a much smaller percentage of military retirees.

If the taxpayer does not have a DOD disability retirement, the calculation for the net disability exclusion is inappropriate. If the taxpayer has made the appropriate elections and has a DOD disability retirement, then the DOD would have all the information to make a timely calculation if the net disability exclusion is applicable. Therefore, Form 1099-R is correct as provided to the taxpayer.

Based upon evaluation of the relevant and judicial precedents as described above, a taxpayer's full concession of the issue is appropriate.