



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
March 31, 1999

OFFICE OF  
CHIEF COUNSEL

Number: **199921043**

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WTA-N-103300-99  
CC:EBEO:2:LEAlsalihi

UILC: 112.01-00

MEMORANDUM FOR

FROM: CHIEF, BRANCH 2, EMPLOYEE BENEFITS AND EXEMPT ORGANIZATIONS, CC:EBEO:2

SUBJECT: COMPUTATION OF EXCLUDED MILITARY RETIRED PAY UNDER INTERNAL REVENUE CODE SECTION 122.

This responds to your request, dated January 29, 1999, for assistance concerning the computation of excluded military retired pay under section 104(a)(4) of the Internal Revenue Code and section 1.122-1 of the Income Tax Regulations. Your request involves claims for refund filed by taxpayers on the basis that a portion of their military retired pay is excluded from gross income.

Your inquiry does not relate to a specific taxpayer. Rather, you provided a sample set of facts representing a typical claim. In that sample, a taxpayer retired from the armed forces and receives military retired pay based on years of service from the Department of Defense (DOD). The taxpayer was not retired for disability but subsequently applied to the Veterans Administration (VA) for disability benefits under Title 38 of the U.S. Code. The VA determined that the taxpayer had a 10% disability and he elected to waive his DOD years of service retirement benefits to the extent of his VA benefits so that he could receive the VA benefits tax free. The taxpayer also elected to reduce his DOD retirement under the Survivor Benefit Plan.

In computing his taxable retirement benefits under section 1.122-1(d) of the regulations, the taxpayer first constructed a retired pay base equal to what would have been used under 10 U.S.C. §1401 to compute his retired pay on the basis of years of service as if he had been retired for disability (referred to as his "adjusted gross retirement pay"). The taxpayer made this computation by dividing his gross retired pay (reported retired pay plus the VA waiver reduction and Survivor Benefit Plan reduction) by the percentage used under 10 U.S.C. §1401 (2.5% x years of service). He then multiplied this constructed retired pay base by the percentage of

disability awarded by the VA and subtracted the amount waived from his service retirement to arrive at a “net disability exclusion.” The taxpayer then filed a Form 1040X reducing the amount of gross income reported by the “net disability exclusion.” The gross income had already been reduced by the amount waived to receive VA compensation. The taxpayer asserts that the “net disability exclusion” was excludable under section 104(a)(4) of the Code and this treatment is sanctioned by Example (4) of section 1.122-1(d) of the regulations.

Under section 122 of the Code, gross income of a member or former member of the Armed Services does not include the amount of any reduction in his retired or retainer pay pursuant to a Survivor Benefit Plan election.

Section 1.122-1 of the regulations provides the order in which various reductions (including Survivor Benefit Plan reductions) in gross retired pay (GRP) will be deducted in computing net taxable retired pay where there are multiple reductions pursuant to different statutory provisions.

Section 1.122-1(d) of the regulations provides examples with respect to the Retired Serviceman’s Family Protection Plan. However, section 1.122-1(e) provides that the same principles as set out in (d) apply to the Survivor Benefit Plan.

Under Example (4) of section 1.122-1(d), Taxpayer B retired from the armed forces and received disability retired pay under 10 U.S.C. §1401 with a DOD disability rating of 30%. B elected benefits under the Retired Servicemen’s Family Protection Plan thereby reducing his GRP as computed under 10 U.S.C. §1401 by \$1,200. B also elected to waive \$1,000 of his DOD disability retired pay in order to receive disability compensation of \$1,000 from the VA. B is required to forfeit retired pay of \$4,088 under 5 U.S.C. §5532. In computing B’s net taxable retired pay under Example (4), his GRP is first reduced by the Retired Servicemen’s Family Protection Plan amount ( $\$11,250 - \$1,250 = \$10,000$ ). Next, the amount of DOD disability retirement benefit waived is subtracted ( $\$10,000 - \$1,000 = \$9,000$ ). Next, the portion of B’s DOD disability retirement otherwise excludable from gross income under section 104(a)(4) of the Code ( $\$4,500$ ) is reduced by the amount of retired pay waived to receive VA compensation ( $\$1,000$ ) and the resulting  $\$3,500$  ( $\$4,500 - \$1,000 = \$3,500$ ) is subtracted from his remaining GRP ( $\$9,000 - \$3,500 = \$5,500$ ). A pro-rata portion of his forfeited compensation is then subtracted from the remaining GRP ( $\$5,500 / \$9,000 \times \$4,088 = \$2,498$ ). B has taxable retired pay of  $\$3,002$  ( $\$5,500 - \$2,498 = \$3,002$ ).

In general, under section 104(a)(4) of the Code, gross income does not include amounts received for personal injuries or sickness resulting from active service in the armed forces.

Subsection (D) of section 104(b)(2) provides that section 104(a)(4) will apply to an individual if, on application therefor, he would be entitled to receive disability compensation from the VA.

Section 104(b)(4) of the Code provides that in the case of any individual described in section 104(b)(2), the amount excludable under subsection (a)(4) for any period with respect to any individual, shall not be less than the maximum amount which such individual, on application therefor, would be entitled to receive as disability compensation from the VA.

The amount of armed forces disability retired pay is computed under 10 U.S.C. §§1401 or 1402. Under those provisions, the retiree may elect either an amount of pay based on percentage of disability or years of service. However, under 10 U.S.C. §1403 that portion of a retiree's armed forces disability retired pay computed under 10 U.S.C. §§1401 or 1402 on the basis of years of service which exceeds the armed forces disability retired pay he would receive based on percentage of disability is not excludable under section 104(a)(4) of the Code. The taxpayer in Example (4) received a DOD disability retirement benefit computed under 10 U.S.C. §1401 by multiplying his retired pay base by 2.5% times his years of service.

The facts presented in Example (4) are distinguishable from the facts presented in the instant case. The taxpayer in Example (4) was retired from the armed forces because of disability (*i.e.*, because he was unfit for duty) not because of his years of service. Accordingly, his retired pay was received "for personal injury or sickness" as required under 104(a)(4) of the Code. Thus, his 10 U.S.C. §1401 disability retirement benefit (limited by 10 U.S.C. §1403) was excludable under section 104(a)(4).

On the other hand, the taxpayer in the instant case was retired for years of service, not for disability. No part of his retired pay was "received for personal injury or sickness" as required under section 104(a)(4)<sup>1</sup>. Thus, in computing his taxable retired pay under Example (4), his GRP was properly reduced by the amount waived in order to receive excludable VA benefits. Unlike the taxpayer in Example (4), however, his GRP should not be further reduced under section 104(a)(4) because it was not "received for personal injury or sickness," a

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<sup>1</sup> In *Sidoran v. Commissioner*, 38 T.C.M. 226 (1979), *aff'd* 640 F.2d 231 (9th Cir. 1981) the Court stated at 233 "Thus, disability retirement standards differ from the Veterans Administration's service connected disability compensation criteria, ... and a Veterans Administration disability rating of forty percent is not determinative of the issue of whether the serviceman was qualified for disability retirement."

prerequisite to that exclusion. Moreover, to the extent sections 104(b)(2)(D) and 104(b)(4) may create an exception for amounts previously received as service retirement (which correspond to the VA disability payments), the exception would not be applicable in this case because the taxpayer filed a waiver equal to the amount of his VA compensation. Because the taxpayer has already reduced his taxable retired pay by the amount of the VA benefits, he should not be entitled to a second exclusion of 10% of his base pay under section 104(a)(4) on account of the same VA disability determination. We have attached a chart outlining the way we believe the taxpayer's computations in the instant case should have been made under Example (4) of section 1.122-1(d).

Please contact Branch Two at (202) 622-6040 or Branch Six at (202) 622-6080 if you have any questions.

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Jerry Holmes  
Chief, Branch 2,  
Employee Benefits and  
Exempt Organizations

Attachment

Attachment

|  | EX (4)          | Taxpayer        |
|--|-----------------|-----------------|
| Gross Retired Pay.....                                   | \$11,250        | \$46,328        |
| Less: Section 122(a) exclusion .....                     | <u>( 1,250)</u> | <u>( 126)</u>   |
| Reduced Retired Pay .....                                | \$ 10,000       | \$46,202        |
| Less: Retired pay waived to receive VA compensation..... | <u>( 1,000)</u> | <u>( 1,046)</u> |
| Adjusted Retired Pay .....                               | \$ 9,000        | \$45,156        |

|  | EX (4)            | Taxpayer |
|--|-------------------|----------|
| Less: (i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403 ..... | \$ 4,500          | 0        |
| (ii) Less: Retired pay, not to exceed (i), waived to receive VA compensation .. .....                | <u>(\$1,000)</u>  | <u>0</u> |
| (iii) Net disability exclusion .....   | <u>(\$ 3,500)</u> | <u>0</u> |

|   |          |          |
|---|----------|----------|
| Taxable retired pay before adjustment for dual comp. forfeiture ..... | \$ 5,500 | \$45,156 |
|---|----------|----------|

Less: Adjustment for dual comp. forfeiture of \$4,088

|  |                |          |
|--|----------------|----------|
| $\begin{array}{r} 5500 \\ \hline \end{array} \times \$4,088 = \$2,498 \text{ (rounded)} .....$ | <u>(2,498)</u> | <u>0</u> |
|--|----------------|----------|

9000

|                               |         |          |
|-------------------------------|---------|----------|
| Net taxable retired pay ..... | \$3,002 | \$45,156 |
|                               | =====   | =====    |