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A Step By Step Guide: Preparing a Return for a Disabled Veteran



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There are several different types of disability compensation for retired military members. Unlike regular military retirement compensation, disability compensation is nontaxable. The tax treatment of disability compensation depends on when the disability was awarded, who awarded it, and the type of award.

OBSERVATION: The Defense Finance and Accounting Service (DFAS) is responsible for withholding and reporting taxes for any taxable retirement payments on IRS Form 1099R. DFAS is a division of the Defense Department. For a complete list of the types of disability compensation for which veterans are eligible, please visit the DFAS website at <http://www.dfas.mil/retiredmilitary/disability/disability.html>

Common Types of Disability Claims

While there are many different types of disability claims for which compensation is available, the following three are the most common:

- (1) Veterans Administration (VA) Disability Award (Code Sec. 104(a)(4); Rev. Rul. 78-161; 38 U.S.C. Section 3010(a))
- (2) Concurrent Retirement and Disability Payments (CRDP) (IRM Section 21.6.6.3.20)
- (3) Combat Related Special Compensation (CRSC) (IRM Section 21.6.6.3.30)

Internal Revenue Manual (IRM) Section 21.6.6.3.20 (10/1/12), discusses the tax treatment of these types of disability payments. Often, disability awards are backdated; thus, amended returns are required to obtain tax refunds for amounts originally reported as taxable income but subsequently recharacterized as nontaxable income. The following discussion details the treatment of amended returns for backdated awards, as well as the tax treatment of a current year award.

By far the most common disability compensation award is a VA disability award, where the individual receives a disability percentage rating from the VA. These awards can take years to be approved and are often backdated with the veteran getting a large lump sum payment when the award is finalized. If the veteran appeals a compensation award, and is subsequently awarded a higher percentage, that award may also be back dated and affect a prior tax year.

VA disability compensation is nontaxable to the veteran or survivor and is not reported on any tax forms. The veteran will receive a report showing any adjustments due to cost-of-living adjustments (COLA) or other changes affecting the monthly benefit during the year.

While the disability compensation is not reported on the veteran's tax return, practitioners must know the amount because it will affect the general sales tax option on the veteran's Schedule A. The amount of nontaxable VA benefits must be added to total income when calculating the sales tax using the optional sales tax tables.

OBSERVATION: The general sales tax deduction is frequently up for review with other sunset tax breaks and could be phased out at any time. It was recently extended to years beginning before 2014 by the American Taxpayer Relief Act of 2012.

CRDP is a program that started phasing in during 2004 over a 10 year period for veterans with a disability percentage of over 50 percent. This program allows them to receive their military retirement and their disability compensation without one offsetting the other. Each year from 2004 2014, the offset from the retired pay by the VA goes down until it is completely phased out after 2014. When a veteran is granted a VA disability percentage during the year and it is backdated into previous tax years, specific information is necessary to prepare the return and any amended returns correctly.

Preparing a Return for the Year of a Disability Award

When a veteran is awarded VA disability compensation that increases amounts he or she is already receiving, the veteran will receive a letter with columns listing:

- (1) Rate Entitled - This is the total rate of VA disability compensation that the veteran is entitled to based on the new/updated award.
- (2) Rate Paid - This is the amount of VA nontaxable income the veteran was receiving.
- (3) Amount Withheld - This is the amount of the VA income that the veteran did not receive because it was offset by the taxable military retired pay.
- (4) Effective Date - This is the effective date of the new/updated compensation payments.

Compliance Tip: Important items to note for the filing of the tax return are the date of the award, the file number, the monetary calculations, and the signature page. Copies of all of these are necessary and should be attached to the return. As a result, the return will have to be mailed to the IRS due to the attachments.

OBSERVATION: It is important to remember that when dealing with the VA, dates on the letters are misleading. Payments begin the first day of the month after the veteran becomes entitled to the new/updated compensation payment. Thus, a new compensation amount with an effective date of December 1 is not actually paid to the veteran until January 1 of the following year, so always keep that in mind when adding the amounts for adjustments. (38 U.S.C. Section 5111)

It is important to note that, until the VA award has been processed, the military retirement form (DFAS) 1099R will reflect the full amount of pension the taxpayer received for the year. DFAS will not go back and correct or back out the amount of the pension that should have been nontaxable from the first of the year until the award date. Thus, the tax preparer must make the appropriate adjustments on the veteran's return.

In the year of the original award or updated award, the original Form 1040 should be completed as follows:

(1) All tax information reported to the taxpayer is entered on the appropriate lines (e.g., enter the amount reported on the Form 1099-R sent by DFAS on the pension income line on Form 1040).

(2) An adjustment is necessary to the amount reported on Form 1099-R (and, thus, the pension income line of Form 1040) and is calculated by using the following formula:

Amount withheld x Number of months in the year that particular amount was withheld

Example: Assume a veteran receives a VA award letter, dated February 2013, with an award backdated to July 1, 2012. The letter shows that for tax year 2012, the taxpayer had \$538 withheld from July 1 thru October 1, 2012, and had \$340 withheld from October 1 thru December 1, 2012. Because payments begin a month after the date of the award, the July 1 payment was actually received in August and so on. Thus, for the 2012 tax year, the adjustment is \$2,294 (\$1,614 (\$538 3) + \$680 (\$340 2)).

(3) The adjustment is reported on the Other income line of Form 1040 as a negative number with the notation VA Disability Adjustment See Attachments included on the dotted line.

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- (4) The return is completed as normal and prepared for mailing.
 - (5) A copy of the Form 1099-R from DFAS and all other reporting documents that are normally required are attached to the return.
 - (6) A copy of the first page, all pages with monetary computations, and the signature page of the VA award letter are attached to the return.
 - (7) At the top of the Form 1040 and the top of the VA award letter, a notation should be added that says VA Disability Award.
 - (8) The veteran's social security number should be included on all pages of the return and all attachments.

Compliance Tip: An adjustment may be necessary on the veteran's state return. For example, in Louisiana, an adjustment is required on LA 540, Schedule E. The starting point for the Louisiana return is the federal adjusted gross income (AGI) amount, and military retirement is deducted on Schedule E. Normally, the taxpayer reports any retirement amount from Form 1099-R on the Schedule E; however, where there was VA disability adjustment, for instance, the starting point already has the negative adjustment for the VA award in it, so the practitioner must add that back into income on the state return or the taxpayer would have a double deduction. Additionally, if the taxpayer is over 65, special state subtractions may come into play for pension amounts reported on the federal return. If the reported amounts of pension income are backed out somewhere else on the federal return (e.g., as a negative adjustment on the Other income line), practitioners must be careful that the special state subtraction is reversed.

Amending Prior Year Returns Affected by Backdated Disability Awards

When an award is backdated into a prior tax year, an amended return must be filed for a tax refund. Special limitations periods apply to backdated VA disability awards. In such cases, the normal three-year statute of limitations for filing a refund claim is extended, for purposes of permitting a credit or refund based on the amount of the award, until the end of the one-year period beginning on the date of such determination. Thus, if a veteran received an award on a letter dated June 2012 and the award was backdated to February 2005, the veteran can amend tax returns from 2008 to 2012 (i.e., June 2012 is extended to June 2013, and the five prior-year returns as of that date would be returns for 2012, 2011, 2010, 2009, and 2008). However, in no case does the statute extend to any tax year that began more than five years before the date of such determination.

OBSERVATION: The five-year limitation period can be detrimental in situations where a veteran has had to litigate over a long period of time to get a disability award. In *Haas v. U.S.*, 2012 PTC 261 (Fed. Cl. 2012), a veteran began pursuing disability compensation in 2001 as a result of his military service, and was finally awarded a 100 percent disability rating. Ultimately, he was successful in establishing that he had been exposed to Agent Orange. The ruling granting the award occurred eight years after the veteran's initial claim was filed and over five years after the Board of Veterans Appeals's original denial of his claim. The VA issued its rating decision on December 1, 2009, in which it found the veteran was 100 percent disabled from July 30, 2001, onward. The veteran applied for a refund for years 2001-2009, based on the fact that the military pay on which he paid taxes was nontaxable. While the court was sympathetic, the veteran was barred from seeking refunds for years 2001-2004.

Compliance Tip: It's important to double check state law to see if the state follows federal law as far as limiting the time for which a refund claim can be made for disability awards.

The process for amending a prior year return for a backdated award is basically the same as preparing a return for a current year award, including double checking whether any change in AGI affects other parts of the return (i.e. itemized deductions, credits, etc).

Compliance Tip: For the explanation on the Form 1040X, a statement similar to the following may be added: Taxpayer received a backdated VA Disability Award on [insert date]. The award letter is attached. Calculations for the adjustment are as follows: [insert calculation]. All changes to the return flow from the adjustment to AGI based on this calculation. Practitioners should include the primary social security number and the notation Retroactive VA Disability Award on the top of the Form 1040X, all tax return pages, and all attachments. If the adjustment has affected other things, like additional schedules and worksheets, these should be attached, even if it is a worksheet normally not sent with an original return.

Combat Related Special Compensation (CRSC)

The Combat Related Special Compensation (CRSC) program is a program managed by the Army, Navy, Air Force, or Marines, and not the VA, for retired veterans. Thus, payments are made by DFAS. Unlike CRDP payments, CRSC payments are nontaxable. Thus, it's important that the veteran knows if he or she is receiving CRDP or CRSC payments. Once DFAS determines that a veteran is eligible for both CRDP and CRSC payments, the veteran is offered a choice of which one to pick and is able to change that choice once a year. This is all done at DFAS and will affect the veteran's DFAS 1099-R.

Other than the original award notification from DFAS, which is usually a postcard with no monetary information on it, a veteran receives an award letter showing his percentage of CRSC award and the effective date. The same rules apply with respect to a DFAS

Form 1099R as apply for a VA award DFAS will not adjust the Form 1099R to remove the backdated award amount.

To compute the adjustment for the year of the award, the practitioner must obtain the percentage award and the award date from the CRSC award letter to the veteran. Once that information is obtained, the practitioner calculates the necessary adjustment for the individual tax years as follows: Total monthly pension (if the veteran has received the pension for the whole tax year simply divide the the Form 1099R, Box 1, amount by 12) CRSC percentage award the number of months the award was received.

The original or amended tax returns are then prepared as discussed above, except that, instead of writing VA Disability Award at the top of the return pages and attachments, CRSC Award should be written on the top of those pages.

About the Author

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