



# Military Income



## Introduction

This lesson will help you determine which income items received by current and former members of the U.S. Armed Forces are reportable on the return, and the status of any medical separation pay or pay related to service in a combat zone.

Community property laws may impact the income reported by some military members on their returns.

## Objectives

At the end of this lesson, using your resource materials, you will be able to determine:

- Which income items received by members of the U.S. Armed Forces are reportable on the tax return and
- The status of any medical separation pay or pay related to service in a combat zone

### What do I need?

- Form 13614-C
- Publication 4012
- Publication 3
- Publication 525
- Publication 555

## What are the types of income?

U.S. Armed Forces members receive many different types of pay and allowances. Some are includible in gross income while others are excludable from gross income.

Refer to the Volunteer Resource Guide, Tab D, Income, for detailed lists of these types of military pay and to determine if they are included in gross income or excluded.

## What income is includible?

Includible items are subject to tax and must be reported on the tax return. The items listed in Publication 3, Armed Forces' Tax Guide, Table 1, and the Volunteer Resource Guide, Tab D, Income, are included in gross income, unless the pay is for service in a combat zone or in a qualified hazardous duty area. All includible military income will generally be shown on Form W-2, box 1, and reported on Form 1040 as wages.



**CAUTION** If the amount shown on Form W-2, box 1, differs from the last Leave and Earnings Statement for the current tax year, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

## What income is excludable?

Excludable income does not have to be reported as income on the tax return. The exclusion applies whether the item is furnished in kind, or is a reimbursement or an allowance.

For example, the Basic Allowance for Housing (BAH) can be excluded from gross income as a qualified military benefit. Excludable income will not be included in the amount on Form W-2, box 1.



If U.S. Armed Forces members were provided a commuter highway vehicle (such as a van) by their employer, refer them to Publication 525, Taxable and Nontaxable Income, and to a professional tax preparer.



## EXERCISES

Answers follow the lesson summary.

**Question 1:** Enlistment and reenlistment bonuses are excluded from a service member's income.

True  False

**Question 2:** Which of the following items is excludable from U.S. Armed Forces members' income?

- A. Student loan repayments
- B. Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) income
- C. Basic pay
- D. Hardship duty pay

## Homeowners Assistance Program (HAP)

HAP was created to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market or when they are required to permanently relocate during the home mortgage crisis. These payments for qualified military base realignments and closures are excluded from income. For additional information go to Publication 3.

## What is military separation with disability severance pay?

Disability severance pay has varying effects on a service member's income and taxes.

### What is severance pay?

U.S. Armed Forces members who have been separated from the military after years of service or for medical reasons are given severance pay, which is generally taxable as wages. If the member receives disability severance pay and is later awarded Veteran's Affairs (VA) disability benefits, 100% of the disability severance benefit may be excluded from income. The VA makes the determination that the member is entitled to medical disability benefits, and the determination process can take several months, and sometimes years.

### What is VA disability compensation?

VA disability compensation is a monetary benefit paid to veterans who are disabled because of injury or disease incurred or aggravated during active military service. The veteran's service must have been terminated through separation or discharge under honorable conditions. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax. The VA does not issue Form W-2, Form 1099-R, nor any other document for nontaxed veteran's disability benefits.



Simplified method for preparing Form 1040X for Disability Severance Payments (DSP) tax refunds is approved as within scope for volunteers with Basic or higher certification. These returns can be prepared without using tax software. A fillable Form 1040X is available at [irs.gov](http://irs.gov).

## What happens after a service member receives a letter of determination?

Once the VA sends a letter of determination, all future pension payments from the government are offset by the disability amount paid directly from the VA. Disability payments received directly from the VA are not taxable and are not included on Form W-2 or Form 1099-R.

Although pension payments made before the letter of determination was issued have already been taxed, the letter exempts from taxes the same amount of previous pension payments. U.S. Armed Forces members who have already filed a tax return and reported that pension income should file Form 1040X, Amended U.S. Individual Income Tax Return, and attach a copy of the letter of determination.

**The Combat-Injured Veterans Tax Fairness Act of 2016** allows certain veterans who received lump sum disability severance payments additional time to file a claim for credit or refund of an overpayment attributable to the disability severance payment. Veterans who received disability severance payments paid after January 17, 1991, that were included as taxable income on Form W-2, but were later determined to be nontaxable will receive a notice of the amount of that payment in July 2018.

Anyone who received this notice can file a claim for credit or refund for the tax year in which the disability severance payment was made and was included as income on a tax return. For veterans who received a lump sum disability severance payment after January 17, 1991, this may provide additional time to claim a credit or refund for the overpayment.

Affected taxpayers must complete and file Form 1040X for the tax year the disability severance payment was made and include any necessary documentation, carefully following the instructions in the notice mailed by the Department of Defense. See [irs.gov](http://irs.gov) keyword: Combat-Injured Veterans.



### EXERCISES (continued)

**Question 3:** Disability payments sent directly from the VA to the discharged service member \_\_\_\_\_.

- A. Are taxable
- B. Appear on the taxpayer's Form W-2 or 1099-R
- C. Are not included on the taxpayer's Form W-2 or 1099-R
- D. May begin before the VA issues the letter of determination

### example

Anita Zapata was an active duty service member who was separated due to a medical condition, and began receiving her military pension in February of the previous tax year. Here are the payments she reported on that year's tax return:

<i>Payments</i>	<i>Amount</i>
• Disability severance pay	\$10,000
• Service pension	\$33,000
• Active duty pay	\$ 5,000

In the current tax year, the VA determined that she was retroactively entitled to a VA disability pension of \$837 each month from the date of her discharge (February of the previous tax year). She can amend her tax return to exclude \$9,207 ( $\$837 \times 11$  months) of the pension she received plus the entire \$10,000 disability severance payment.

She must attach a copy of her letter of determination to the amended return. Her current tax year Form 1099-R will not include the nontaxable VA disability retirement payments received during that year.

## What is a combat zone?

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A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Publication 3 lists the specific areas and dates.



A taxpayer serving in a combat zone may qualify for relief from certain IRS compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may notify the IRS directly of their status through a special e-mail address: [combatzone@irs.gov](mailto:combatzone@irs.gov). They should provide name, stateside address, date of birth and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative. For more information visit [irs.gov](http://irs.gov).

Hazardous duty areas are determined by Congress. Members of the Armed Forces deployed overseas, away from their permanent duty station, in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone for federal income tax purposes.

## What is the combat zone exclusion?

Members of the U.S. Armed Forces who serve in a combat zone may exclude certain pay from their income. The entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized due to wounds, disease, or injury incurred while serving in the combat zone. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone.

The following section is to help you understand when pay is considered excludable as combat pay. You will not be making any decisions about what is excludable. The information on the military member's Form W-2 indicates the amount of combat pay with a code Q. If military members feel the amount is incorrect, refer them to the local accounting and finance or payroll office for clarification. Do not change any amounts on Form W-2 when entering them in the tax software.

## What qualifies as service in a combat zone?

Service in a combat zone includes periods that military members are absent from duty because of illness, wounds, or leave. If, as a result of serving in a combat zone, military members become prisoners of war or are missing in action, they are considered to be serving in the combat zone as long as they remain in that status for military pay purposes.

## When does service outside a combat zone qualify as service inside a combat zone?

Military service outside a combat zone is considered to be performed in a combat zone if the service:

- Is in direct support of military operations in the combat zone, and
- Qualifies a member for hostile fire/imminent danger pay due to dangers or risks from the combat zone

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

## What is nonqualifying presence in a combat zone?

The following military service does not qualify as service in a combat zone:

- Presence in a combat zone while on leave from a duty station located outside the combat zone
- Passage over or through a combat zone during a trip between two points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience

### example

Sgt. Bobby Osage was not assigned to a combat zone but he performed duty that qualified for hostile fire pay. He can exclude that income.



U.S. service members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.



## EXERCISES (continued)

**Question 4:** Which of the following may qualify as service in a combat zone?

- A. Temporary duty in a combat zone
- B. Traveling through a combat zone between two points outside of the combat zone
- C. Presence in a combat zone while on leave from a duty station located outside the combat zone
- D. Direct support of a qualified hazardous duty area but not entitled to hostile fire/imminent danger pay

## What is the amount of the combat zone exclusion?

- Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month (even one day) can exclude all of that month's military pay, including awards and re-enlistment bonuses for which the member becomes eligible while in the combat zone. Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded.
- Commissioned officers (including limited duty officers) may exclude pay according to the rules for enlisted members. However, the amount of the exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay received for each month during any part of which they served in a combat zone or were hospitalized as a result of their combat zone service.

Combat pay is not included in box 1 wages on the service member's Form W-2, but the amount is shown in box 12, with code Q. If service members believe the taxable wages on Form W-2 are incorrect, they should contact the local accounting and finance or payroll office to request a corrected Form W-2.

Nontaxable combat pay may increase the Child Tax Credit or Earned Income Tax Credit. Enter all fields from Form W-2 when preparing the tax return. The software will determine what is most beneficial to the taxpayer.



**Tax Software Hint:** To review information related to the software, go to the Volunteer Resource Guide, Tab K, Finishing the Return, for the entries related to combat zone, "Special Processing."

## Taxpayer Interview and Tax Law Application

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Here's how a volunteer might help taxpayers with combat pay:

### SAMPLE INTERVIEW

VOLUNTEER SAYS...

*Let's talk for a minute about where your husband was stationed.*

*The combat pay is not taxable, but it's shown on your husband's W-2, here in box 12, with code Q. I will enter that into the system with the rest of the W-2 information, because combat pay can increase some tax credits. I can show on the tax return that he was in the combat zone, but I don't need to know the exact dates. Is he serving in Iraq?*

MRS. FANNIN RESPONDS...

My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything?

That's right.

## What are the laws regarding community property?

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The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Special rules apply to married taxpayers who file separately or who were divorced during the tax year and their **domicile** is in a community property state. For military members residing in these states, the key word is domicile, which describes someone's legal, permanent residence. It is not always where the person presently lives.

Married taxpayers who choose to file separately, when subject to community property rules, have to figure community income and separate income for state and federal income tax.

## How do community property laws affect Armed Forces pay?

State community property laws apply to active military pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the service member was/is in active military service.

Whether an item is subject to community property laws depends on whether the payment is classified as active pay or retired/retainer pay:

- State community property laws apply to active military pay. Generally, the character of the pay as separate from community income is determined by the marital status and domicile of the service member and spouse while the member is on active military service.
- Armed Forces retired or retainer payments may be subject to community property laws. For more information see Publication 555, Community Property.

## Summary

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Special rules may govern whether certain income received by members of the U.S. Armed Forces is includable or excludable from taxable income reported on the return:

- Homeowners Assistance Program (HAP)
- Medical separation with disability severance pay
- Combat zone exclusion
- Community property laws

### What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- U.S. Armed Forces members who were provided a commuter highway vehicle (such as a van) by their employer



### TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study on TaxSlayer.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L&LT.



### EXERCISE ANSWERS

*Answer 1: False. The payments and withholdings for the enlistment and reenlistment bonuses are reflected on the service member's Form W-2.*

*Answer 2: B. The Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) are both nontaxable income.*

*Answer 3: C. Once the VA sends the letter of determination, all pension payments are offset by the disability amount paid directly from the VA, which is not taxable and not included on any Form W-2.*

*Answer 4: A. Military members are considered to be serving in a combat zone if they are either assigned on official duty to a combat zone or they qualify for hostile fire/imminent danger pay while serving in direct support of a combat zone.*