

CHAPTER 8: FEDERAL TAX ISSUES

Introduction

This chapter provides general information about certain U.S. federal income tax rules that may be relevant to military personnel and some information that will be of specific interest to disabled service members, their spouses and family members. In addition, this chapter discusses powers of attorney and steps that are necessary to allow someone to file a tax return on behalf of a disabled service member. It is not intended to provide specific tax advice or to take the place of a consultation with a tax professional, such as a certified public accountant or a tax attorney. **This chapter only discusses U.S. federal income tax rules and does not cover state or local tax rules, which may be different from the federal rules discussed in this chapter and may differ from state to state.**

Because this section is only a general summary, it omits many details about the federal income tax rules it describes. Many of these details, along with answers to questions veterans and their families may have, can be found in IRS Publication 3, *Armed Forces Tax Guide*, and Publication 907, *Tax Highlights for Persons with Disabilities*. These publications, along with other IRS forms and publications, may be obtained from the IRS website at www.irs.gov or by calling (800) 829-3676. Additional information addressing how to find answers to your tax questions, including the websites of state tax authorities, can be found in *Chapter 11, State Resources*. **Veterans and their families are also strongly encouraged to consult with a tax professional for advice about their particular circumstances and for answers to any questions they may have.** Under most circumstances, a certified public accountant should suffice.

Tax Basics

How do I pay taxes? Is that the same as filing a tax return?

In general, federal taxes must be paid on all income, including wages, interest earned on bank accounts, etc. Most individuals' income taxes are paid when their employers withhold wages from their paychecks. Taxpayers may recoup a portion of their withholdings by filing a tax return, which enables them to receive a tax refund.

What types of tax benefits may service members receive?

Certain tax benefits are particularly relevant to service members and their families. Some tax benefits may arise as a result of a service member serving in a combat zone, while other benefits may arise as a result of certain expenses incurred by the service member. Tax benefits most often take the forms of exclusions, deductions and credits.



- > **Exclusions** are sums of money received that are not taxed and do not have to be reported as “income” on tax returns. For instance, a service member may be eligible for the Combat Zone Exclusion, in which case the excluded wages are “tax-free.” See the section titled “Exclusions: The Combat Zone Exclusion” below.
- > **Deductions** reduce the amount of money on which taxes are due. For instance, expenses incurred in modifying a home to accommodate a disability are generally tax deductible if the modification does not increase the value of the home. For example, if a service member spends \$5,000 making her home wheelchair accessible, she may be allowed to deduct that expense if that improvement did not increase the value of her home. This does not mean that the service member pays the government \$5,000 less in taxes. Rather the service member **may be allowed to reduce her taxable income** by \$5,000 for the tax year. See the section titled “Deductions” below.
- > **Credits** directly offset the amount owed in tax. For instance, a service member who receives a \$1,000 Disabled Tax Credit will owe \$1,000 less in taxes, or will receive a refund of \$1,000 after filing his or her tax return. See the section titled “Tax Credit for the Disabled” below.

Income Tax Returns

When are tax returns due?

The regular due date for tax returns is April 15 of the year following the calendar year for which the return is filed. Most individual tax returns cover a calendar year, January through December. If April 15 falls on a Saturday, Sunday, or legal holiday, then the due date is the next business day.

Extensions are generally available upon a timely request. Certain military personnel are entitled to automatic extensions.

Who is entitled to an automatic extension to file a tax return?

The deadline for filing tax returns, paying any tax due and taking other actions with the IRS is automatically extended for those serving and those hospitalized as a result of injuries incurred while serving in the Armed Forces in a combat zone, in a qualified hazardous duty area or on deployment outside of the United States while participating in a contingency operation. Service members also receive automatic extensions if they are performing qualified service outside of a combat zone, meaning service that is in direct support of military operations in a combat zone **and** which qualifies for special military pay due to imminent danger or hostile fire. A combat zone is any area the President designates as an area in which the United States is engaging in combat.

The deadline for taking actions with the IRS is extended 180 days after the last day the service member is in a combat zone or other qualifying situation described above or the last day of any qualified hospitalization due to an injury from service in one of the qualifying situations described above, whichever is later.



What is the process for requesting an extension for filing a tax return if an automatic extension does not apply?

In order for a 6-month extension to apply, U.S. residents must file IRS Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Tax Return*, by the regular due date of the return (generally April 15, as discussed above). Since the extension to file is automatic, no notice of approval will be received. However, if the request is not filed by the regular due date, the request will be denied and notification of the denial will be issued by the IRS. An automatic extension may not be available to all taxpayers. See IRS Form 4868 for further details and instructions.

If a taxpayer requests and receives an extension for filing an income tax return, does he or she also receive an extension for the payment of any taxes owed?

No. An extension of time to file a tax return does not mean the taxpayer receives an extension to pay the amount of any taxes that are due. Generally, if a taxpayer requests an extension, he or she should estimate and pay the amount of tax due by the regular due date. Interest generally will be charged on any unpaid tax liability from the regular due date to the date the tax is finally paid. Also, penalties may be charged unless there is reasonable cause for late payment.

Filing Returns on Behalf of Disabled Veterans

What if the service member is unable to complete and file a tax return due to hospitalization or injury?

A power of attorney is necessary in order to file and sign a return on behalf of a service member. When using a power of attorney to file a tax return on behalf of the grantor, the attorney-in-fact must sign the tax return and attach the power of attorney.

There are several different kinds of powers of attorney. Powers of attorney can either be “general” or “limited.” Under a limited power of attorney, the attorney-in-fact may only act on the grantor’s behalf within certain limited circumstances. A power of attorney can also be durable or nondurable. Nondurable powers of attorney cease to be effective when the grantor becomes incapacitated, whereas durable powers of attorney persist through incapacitation. Taxpayers may use the IRS Form 2848, *Power of Attorney and Declaration of Representative*, as a limited power of attorney for tax matters. The IRS form may only be used in particular circumstances and only allows the grantor to assign powers to a limited class of people such as attorneys, accountants, employees and immediate family members. IRS Form 2848 is available online at www.irs.gov/pub/irs-pdf/f2848.pdf.

If a taxpayer uses the IRS Form 2848, it only allows the grantor to assign powers to a limited class of people such as attorneys, accountants, employees and immediate family members.

If a spouse is filing a joint return with a service member who cannot sign due to injury or disease, the spouse may sign on the service member’s behalf. The spouse should sign the service member’s name in the appropriate place followed by the word “by,” then the spouse’s name, followed by the word “husband” or “wife.” In addition, the spouse must



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PROJECT**

attach a statement that the service member has agreed to the spouse signing on his or her behalf, which must include the form number of the return being filed (e.g., IRS Form 1040), the tax year and the reason the service member cannot sign the return. Legal guardians for service members may sign the return as guardian.

What if the service member has not signed a power of attorney, and is unable to do so because of injury or hospitalization?

If the service member has not signed a durable power of attorney and becomes incapacitated, only a court appointed representative may sign tax returns or other legal forms on his or her behalf. This is the case even if the service member previously signed a nondurable power of attorney. In the event of incapacitation without a durable power of attorney, the service member's family should seek legal advice on how to manage the service member's affairs.

As noted above, there is an automatic extension for filing a tax return of 180 days from the date of the service member's release from qualified hospitalization. No action is necessary to claim this extension.

Exclusions – The Combat Zone Exclusion

Are there any special U.S. federal income programs available to reduce the tax burden of service members?

Yes. Congress has created the Combat Zone Exclusion program to reduce the income taxes owed by service members who serve in combat zones. The Combat Zone Exclusion permits the exclusion of certain pay from income as the result of having served in a combat zone or other qualifying service. This means that the amounts that qualify for the exclusion do not have to be reported as income on any tax returns thereby making those amounts "tax-free." Under many circumstances, the military will automatically adjust withholding to account for the Combat Zone Exclusion so that whoever prepares the income tax return will not need to make a separate adjustment to receive the tax-free treatment of qualifying income. However, service members may wish to have a tax professional verify that this has been done correctly.

If a service member has served in a combat zone or performed other qualifying service during part of any month, all of the military pay received for that month is excluded from income, subject to certain limits for commissioned officers.

A service member generally will be eligible for the Combat Zone Exclusion during periods in which any of the following apply:

- > the service member was assigned on official temporary duty to a combat zone;
- > the service member qualified for hostile fire or imminent danger pay while in a combat zone or while performing other qualifying service;
- > the service member became a prisoner of war or was missing in action;
- > the service member was outside of a combat zone but served in direct support of military operations in a combat zone; or



- > the service member was hospitalized as a result of wounds, disease or injury incurred in a combat zone, except that the exclusion does not apply for any month more than two years after the termination of combat activities in the combat zone, as specified by the President.

Deductions and Credits

Medical Care

Are expenses related to medical care deductible?

Yes. A wide variety of medical expenses may be deducted, including artificial limbs, wheel chairs, psychiatric care and therapy, long-term care, and many other expenses. However, deductions related to medical expenses are only permitted to the extent the expenses exceed a certain percentage of an individual's income. For a complete listing of permissible deductions, as well as the rules for when medical expense deductions may be taken and instructions on how to figure and report medical expense deductions, consult IRS Publication 502, *Medical and Dental Expenses*.

Disability-Related Home Modifications

Can expenses incurred in modifying a home to accommodate a disability be deducted?

Generally, expenses incurred in modifying a home to accommodate a disability are considered medical expenses. Permanent improvements are deductible to the extent that they do not increase the value of a service member's home. In other words, the difference between the cost of the improvement and the amount that the value of the property increased is the deductible medical expense. For example, if a service member had an elevator installed in her home at a cost of \$8,000 and the elevator increased the value of the home by \$4,500, he or she would have a deductible medical expense of \$3,500.

However, many common disability related improvements do not generally increase the value of a property, and, in such a case, the full cost can be included as a medical expense. For a list of examples, see IRS Publication 502, *Medical and Dental Expenses*. Amounts spent to maintain disability-related home modifications also qualify as medical expenses. Expenses incurred in modifying a home are subject to the same limitations on deductions as other medical expenses.

Tax Credit for the Disabled

Is there a federal tax credit for the disabled?

Yes, depending on their income, those service members who (1) are U.S. citizens or residents, (2) have retired on permanent and total disability and (3) if under age 65, receive taxable disability benefits, may be eligible for a disability tax credit. It is important to note that because VA and DoD disability benefits are **not** taxable, these payments cannot make a service member eligible for a credit; he or she will need some other source of disability benefits.



For the purposes of the disability tax credit, permanent and total disability means that a service member cannot engage in substantial gainful activity. Substantial gainful activity involves the performance of significant duties over a reasonable period of time while working for pay or profit.

Taxable disability benefits must be paid under an employer's accident or health plan while a service member is away from work due to a disability. Taxable disability income that is not provided by an employer's accident or health plan, like SSDI, cannot make one eligible for the tax credit.

How does a service member claim the disability tax credit?

Individuals seeking to claim the disability tax credit must provide a physician's statement certifying that they are disabled with their tax return. Disabled service members can substitute VA Form 21-0172, *Certification of Total and Permanent Disability*, for the physician's statement. VA Form 21-0172 can be obtained from VA regional offices.

How is the amount of the credit determined?

Service members applying for the disability credit can either choose to calculate the amount of the credit themselves or have the IRS do so for them. Service members wishing to calculate the credit themselves must complete Schedule R (if filing Form 1040) or Schedule 3 (if filing Form 1040A) of their tax return form. Alternately, service members can return the above forms with "CFE" printed on the dotted line next to line 49 on Form 1040 or line 30 on Form 1040A and the IRS will figure their credit for them. For more information on this credit see IRS Publication 524, *Credit for the Elderly or the Disabled*.

Employer/Employee Tax Credits and Deductions

Disabled Access Credit

Do employers receive a tax credit for expenses related to accommodating a disability?

Employers with 15 or more employees are required to comply with the Americans with Disabilities Act of 1990 (ADA) by making reasonable accommodations for employees with disabilities (see *Chapter 9, Legal Rights*, for more details on the ADA). This may include physical modifications to make facilities wheelchair accessible or the purchase of special equipment. The Disabled Access Credit was created to allow small businesses to receive a tax credit for expenses incurred in making such accommodations in order to comply with the ADA. For examples of permissible expenses see the Instructions to IRS Form 8826, *Disabled Access Credit*.

Impairment-Related Work Expenses

Can expenses incurred in helping a disabled service member perform his or her job be deducted?

Generally, yes. Any service member with a physical or mental disability that limits his or her ability to be employed or substantially limits one or more major life activities can deduct impairment-related work expenses. Impairment-related work expenses are



expenses that are necessary for a service member to be able to work, such as attendant care services. Generally, to qualify as impairment-related, an expense must be (1) necessary for a disabled service member to perform their work satisfactorily, (2) not used for the service member's personal activities, and (3) not be specifically covered under any other tax provision. An example of a qualifying expense would be a reader for a blind service member who assists the service member in doing his or her work, where the service member pays for the reader's services. In this example, the service member is permitted to deduct the cost of the reader.

Service members wishing to deduct impairment-related work expenses must complete IRS Form 2106, *Employee Business Expenses*, or 2106-EZ, *Unreimbursed Employee Business Expenses*.

Financial Assistance Programs

Is disability pay received from the VA or the DoD taxable?

Generally, VA disability pay is not taxable. Under certain circumstances DoD disability pay is not taxable, including disability pay received by a service member as a result of combat related injury. This includes the Individual Unemployability (IU) Program and Combat-Related Special Compensation (CRSC). See *Chapter 4, DoD and VA Disability Compensation* for more information on these programs.

Are VA benefits (other than disability compensation) such as the Automobile and Special Adaptive Equipment grant, Specially Adapted Housing grant and Special Home Adaptations grant, taxable?

No. Benefits received from veterans' programs administered by the VA are not taxable. These benefits are described in greater detail in the section titled "VA Disability Benefits," which can be found in *Chapter 4, DoD and VA Disability Compensation*.

Are TSGLI benefits taxable?

No. Benefits received from the Traumatic injury protection under Service Members' Group Life Insurance (TSGLI) are not subject to tax. TSGLI is discussed in greater detail in *Chapter 1, Immediate Concerns and Family Travel*.

Are Social Security Disability Insurance benefits taxable?

Not unless the service member has additional income. In such cases, Social Security Disability Insurance benefits are only subject to taxation where the service member's additional income exceeds a certain threshold amount.

Education and Employment Benefits

Are benefits received under the GI Bill or other VA-administered programs taxable?

Generally, benefits received under the GI Bill are not taxable and should not be reported as income to the IRS. Benefits (whether monetary or services) received as a part of a VA administered program, including VA Work-Study programs, the Transition Assistance Program, and the Employment Readiness Program, likewise should not be reported as income to the IRS. However, there are certain limited exceptions. Please see IRS Publication 970, *Tax Benefits for Education*, for more information.



Paying for Disability-Related Expenses with Retirement Funds

Individual Retirement Accounts (IRAs) and 401(k) Plans

Can money be withdrawn from an IRA to pay for medical or disability-related expenses?

Generally, funds withdrawn from an Individual Retirement Account (IRA) before the age of 59½ are subject to a 10% penalty in addition to any applicable federal income tax. However, there are exceptions to this rule, including the use of IRA funds for otherwise deductible medical expenses or for use by an individual who has become disabled.

Medical Expenses: Distributions from IRAs for deductible medical expenses (i.e., medical expenses in excess of 7.5% of adjusted gross income) are not subject to the 10% penalty. For further information on what constitutes deductible medical expenses, consult IRS Publication 502, “Medical and Dental Expenses.”

Disability: Service members who become disabled before the age of 59½ and who are unable to engage in any substantial gainful activity because of the disability “incurred” are permitted to make withdrawals from an IRA without penalty. For these purposes, a service member must furnish proof, generally certification from a physician, that he or she cannot do any substantial gainful activity because of a disability.

Can money be withdrawn from a 401(k) account to pay for medical and disability-related expenses?

The rules governing withdrawals from 401(k) accounts are similar to those governing IRAs; funds that are withdrawn from a 401(k) plan before age 59½ generally are subject to a 10% early withdrawal penalty. However, as with IRAs, certain exceptions to the 10% early withdrawal penalty apply if the funds are used for otherwise deductible medical expenses or if the beneficiary of the account has become totally disabled.

Under the rules governing a specific 401(k) account, early withdrawals may be permitted in the case of financial hardship. These rules, however, will vary from plan to plan, and, depending on the circumstances, a financial hardship withdrawal may be subject to the 10% early withdrawal penalty.

Depending on the type of 401(k) account, any withdrawal from the account may be subject to income tax in the year of the withdrawal. Please see the discussion below for the U.S. federal income tax differences between traditional and Roth 401(k) accounts.

Because the rules and procedures governing withdrawals from a 401(k) account before the age of 59½ vary, a service member should speak with his or her plan administrator prior to making any 401(k) withdrawals.



What are the U.S. federal income tax consequences of withdrawals from traditional IRAs/401(k) accounts and withdrawals from Roth IRAs/401(k) accounts?

Contributions to traditional IRAs and 401(k) accounts are not taxed at the time of contribution. Instead, funds withdrawn from such accounts are subject to U.S. federal income tax at the time of withdrawal. In contrast, funds contributed to Roth IRAs and 401(k) accounts are taxed at the time of contribution. Consequently, withdrawals from Roth IRAs and 401(k) accounts are not subject to federal income tax. As a consequence, depending on the type of IRA or 401(k) account that a service member has, any withdrawal from the account may be subject to tax at the time the withdrawal is made.

Regardless of the type of IRA or 401(k) account that a service member has, the 10% penalty for early withdrawal may apply unless the withdrawal qualifies for an exception to the penalty, as discussed above with respect to IRA withdrawals under “*Can money be withdrawn from an IRA to pay for medical or disability-related expenses?*” and with respect to 401(k) withdrawals under “*Can money be withdrawn from a 401(k) account to pay for medical and disability-related expenses?*” or as discussed below with respect to special rules for reservists under “*What are qualified reservist distributions and qualified reservist repayments?*”

What are qualified reservist distributions and qualified reservist repayments?

Reservists and national guard members who were called to active duty between September 11, 2001 and December 31, 2007 for a period of more than 179 days may be eligible to withdraw funds from IRAs and 401(k) accounts without paying the 10% penalty. These withdrawals are known as “qualified reservist distributions.” This exemption from the 10% penalty only applies if the withdrawal was taken between the date of the call to active duty and the close of active duty. Qualified reservist distributions may be taken for any reason.

Reservists and guard members who received a qualified reservist distribution before 2006 and paid the 10% penalty may amend their previous tax returns to claim a refund of the penalty using an IRS Form 1040X.

In addition, reservists and guard members may be permitted to make “qualified reservist repayments” in excess of normal contribution limits equal to the amount of any qualified reservist withdrawals. Such repayments can be made for up to two years after the active duty period ends or until August 16, 2008.

Thrift Savings Plans (TSPs)

Can money be withdrawn from a Thrift Savings Plan (TSP) account to pay for medical or disability-related expenses?

There are two principal ways to withdraw money from a TSP account to cover medical expenses. The appropriate method for a particular service member will depend on his or her specific circumstances.

Most service members can borrow against the contributions and earnings made to his or her TSP account. These loans generally have no tax consequences. However, the loan must be paid back with interest. Payments usually take the form of payroll deductions. Therefore, service members who do not receive monthly pay (i.e., reservists with irregular training intervals) may not be eligible for TSP loans.



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Service members may also withdraw money from their TSP account under what is known as a financial hardship withdrawal. Financial hardship withdrawals are discussed under the section called “Thrift Savings Plan,” which can be found in *Chapter 7, Miscellaneous Federal Benefits*. Financial hardship withdrawals generally are subject to a 10% penalty tax, in addition to the income tax on the withdrawal. However, this 10% penalty generally does not apply if the withdrawal is made because of a permanent and total disability or if the money is used to pay for deductible medical expenses that exceed 7.5% of the service member’s adjusted gross income.

More information on Thrift Savings Plans is available at the TSP website, www.tsp.gov, or by calling the TSP Service Office toll-free at (877) 968-3778. Outside the U.S. and Canada, please call (404) 233-4400 (not toll-free).

Does Combat Zone Exclusion pay contributed to a TSP account receive different tax treatment?

Yes. The 10% penalty does not apply to any portion of a distribution which represents tax exempt contributions from pay earned in a combat zone. Also, Combat Zone Exclusion pay contributed to a TSP account is not taxable when withdrawn, unlike regular pay. However, the interest earned on amounts contributed to a TSP account that were exempt from tax because of the Combat Zone Exclusion is taxable. If a service member receives a distribution from an account that has both Exclusion and non-Exclusion contributions, the distribution will be paid in the same proportions as the service member’s Exclusion and non-Exclusion contributions.

Are taxes withheld from TSP account withdrawals?

Withdrawals from TSP accounts generally must be included in income. As a result, withdrawals are subject to withholding. See *Tax Notice: Important Tax Information About Payments from Your TSP Account*, available at www.tsp.gov/cgi-bin/byteserver.cgi/uniserv/forms/octax92-32.pdf.

State and local taxes are not withheld from TSP Distributions. However, the distributions are reported by the IRS to the service member’s state of residence at the time of the payment. Consequently, a service member generally will be required to pay state and local income taxes on the withdrawal unless an exception applies. Consult a state or local tax official or a tax advisor for more information.

Getting Additional Tax Help

Where can additional tax information be obtained?

IRS Publication 910, *IRS Guide to Free Tax Services*, can be accessed via the IRS website, www.irs.gov, or ordered by calling (800) 829-3676. Service members may call (800) 829-1040 for help with tax questions. Service members may also visit Taxpayer Assistance Centers, which can be located by visiting www.irs.gov/localcontacts/index.html or looking in the phone book under *United States Government, Internal Revenue Service*.

Service members and their families who are unable to resolve a problem through direct IRS assistance at the IRS’s toll-free number above should contact a Taxpayer Advocate by calling toll-free (877) 777-4778, or visiting www.irs.gov/advocate/index.html. The Taxpayer Advocate independently represents taxpayer interests and concerns with the IRS.

