



TAXES & MILITARY DISABILITY SEPARATION PAY

Why were taxes withheld?

Individuals who receive a lump sum disability separation payment will have taxes withheld from their payment by the Defense Finance & Accounting Service (DFAS). Under their interpretation of tax law, DFAS withholds the money in case a person fails to receive a VA rating for their separation disability. However, since most of those separated do receive a rating, you need to know that you can get your money back once you get your VA rating.

NOTE: If you do not act to get the withheld money back then you will lose it and still have the full amount offset by the VA!

How do I get my money back?

Once you get your VA rating for the disability you were separated from the AF for, take proof of the rating to the nearest finance office and cite the DOD Financial Management Regulation, Vol. 7A, Ch. 35 and ask for a refund of the withheld money. Since many finance employees are not familiar with this issue, we have put a copy of their rule on the back of this information sheet for you to give them.

When do I get my money back?

When you get your money depends on when you get your VA rating. If you get your rating the same year you got your separation payment (before the end of the tax year on Dec 31st) you can get it back that year from a finance office as explained above. If you get your VA rating after the end of the year you received your separation payment you will have to get it back when you file your taxes. (Each December 31st, DFAS gives the withheld money to the IRS and so cannot give it back to you as the IRS has it.) Getting it back is easy. Your separation pay goes in with any earned income for that tax year, so you enter the total amount of all W-2s on the "wages, salaries, tips, etc" total income line on the Form 1040 (line 7). You then take that money out of the taxable earnings by entering the excludable separation pay amount as a negative amount (in parenthesis) on the line for "other income" on your Form 1040 (line 21). You need to write on the dotted line an explanation such as "AF disability separation payment" and reference a statement explaining the negative entry. The statement should contain the following information:

Taxpayer's full name and social security number (as they appear on your Form 1040), plus the statement:
A sum in the amount of \$_____ was paid to me as a lump-sum separation disability payment pursuant to my disability discharge from the Air Force on _____ (date). This amount was incorrectly included on my Form W-2. This amount is not taxable as established by St. Clair, 91-2 USTC 50,457 and the subsequent AOD issued by the IRS.

You can also include with the statement any additional proof the money was paid for a disability discharge.

This information sheet was prepared by the HQ AFPC/JA Disability Law Office to provide general guidance. It is not a substitute for the advice of a lawyer or tax professional. If after reading this document you feel you need further assistance, please seek the services of a qualified lawyer or tax professional.

1040 Department of the Treasury—Internal Revenue Service **200** (99) IRS User Only—Do not write or staple in this space.

For the year Jan. 1-Dec. 31, 2000, or other tax year beginning 2000, ending 20

Label See instructions on page 13. Use the IRS label.

LABEL Your first name and initial Last name
If a joint return, spouse's first name and initial Last name
Home address (number and street). If you have a P.O. box, see page 30.

OMB No. 1545-0047
Your social security number
Spouse's social security number

REFERENCE ONLY - DO NOT FILE!

d Total number of exemptions claimed			
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2	7	23,000.00
	8a Taxable interest. Attach Schedule B if required	8a	200.00
	b Tax-exempt interest. Do not include on line 8a	8b	
	9 Ordinary dividends. Attach Schedule B if required	9	
	10 Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
	11 Alimony received	11	
	12 Business income or (loss). Attach Schedule C or C-EZ	12	
	13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	13	
	14 Other gains or (losses). Attach Form 4797	14	
	15a Total IRA distributions	15a	
	b Taxable amount (see page 23)	15b	
	16a Total pensions and annuities	16a	
	b Taxable amount (see page 23)	16b	
	17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18 Farm income or (loss). Attach Schedule F	18	
	19 Unemployment compensation	19	
	20a Social security benefits	20a	
	b Taxable amount (see page 23)	20b	
	21 Other income. List type and amount (see page 23) AF Disability Pay	21	(10,000.00)
	22 Add the amounts in the far right column for lines 7 through 21. This is your total income	22	13,200.00
Adjusted Gross Income	23 IRA deduction (see page 27)	23	
	24 Student loan interest deduction (see page 27)	24	
	25 Medical savings account deduction. Attach Form 8853	25	
	26 Moving expenses. Attach Form 3903	26	
	27 One-half of self-employment tax. Attach Schedule SE	27	
	28 Self-employed health insurance deduction (see page 29)	28	
	29 Self-employed SEP, SIMPLE, and qualified plans	29	
	30 Penalty on early withdrawal of savings	30	
	31a Alimony paid b Recipient's SSN	31a	
	32 Add lines 23 through 31a	32	
	33 Subtract line 32 from line 22. This is your adjusted gross income	33	13,200.00

350404. Taxability and Withholding

A. General. Disability severance pay is normally taxable income. It is not subject to tax withholding or reporting, however, if at least one of the following three conditions exists:

1. On September 24, 1975, the individual was either a member of a Uniformed Service or was under a binding written commitment to become a member;

2. The entitlement resulted from combat-related injury or illness, as determined by the Secretary of the Military Service concerned (or designee), which happens as a result of any of the following activities:

- a. As a direct result of armed conflict,
- b. While actually performing extra-hazardous service, even if the service does not directly involve combat,
- c. Under conditions simulating war, including maneuvers or training, or
- d. By an instrumentality of war, such as weapons.

★ 3. *The member has official notification from the Department of Veterans Affairs (VA) approving entitlement to disability compensation for the same illness or injury that caused the entitlement to disability severance pay. (IC 14-98)*

B. Withholding Taxes. Withhold income taxes on all payments of disability severance pay unless the member qualifies for an exemption under subparagraph 350404.A, above, of this paragraph. Finance or personnel officers should advise members that payments of disability severance pay could become non-taxable if the VA awards disability compensation for the same illness or injury for which disability severance pay was paid.

NOTE: The VA may award disability compensation in either the same tax year or a subsequent tax year in which a member is paid disability severance pay. Once a member is awarded disability compensation, a refund of the income taxes withheld may be requested as discussed in the subparagraphs 350404.C and D, below.

C. VA Compensation Awarded in the Tax Year of Payment. Finance or personnel officers should advise members that a refund of taxes withheld may be obtained from the supporting DFAS Center if disability compensation from the VA is awarded in the same calendar year in which the member received disability severance pay. To obtain a refund from the DFAS, requests must be submitted by December 31st of the year in which a disability severance pay payment is paid. In addition, a member who requests a refund must provide documentation to substantiate that the disability compensation award from the VA was awarded for the same injury or illness for which the member received disability severance pay.

D. VA Compensation Awarded in Tax Year After Payment. Finance or personnel officers should advise members that a refund for income taxes withheld must be obtained from the Internal Revenue Service (IRS) if disability compensation from the VA is awarded in a different calendar year than the year in which the member received disability severance pay. The member also should be advised to submit the appropriate documentation from the VA along with related separation documents to claim a reduction in taxable income. A corrected IRS Form W-2 or other documents to support the decrease in taxable income will not be issued.