

# DEPARTMENT OF TAXATION

## 2018 Fiscal Impact Statement

1. **Patron** Bryce E. Reeves

3. **Committee** Senate Finance

4. **Title** Individual Income Tax; Subtraction for  
Military Veterans with a Permanent Service-  
Connected Disability

2. **Bill Number** SB 473

**House of Origin:**

X **Introduced**

       **Substitute**

       **Engrossed**

**Second House:**

       **In Committee**

       **Substitute**

       **Enrolled**

### 5. **Summary/Purpose:**

This bill would allow an individual income tax subtraction for the amount of the annual retirement compensation received for service as a member of the United States Armed Forces or the Virginia National Guard by a veteran who has been rated by the United States Department of Veterans Affairs ("VA") or its successor agency pursuant to federal law to have a 100 percent service-connected disability. This bill would limit the subtraction to only those taxpayers whose federal adjusted gross income does not exceed 250 percent of the federal poverty level for a four-person household.

This bill would be effective for taxable years beginning on or after January 1, 2018.

6. **Budget amendment necessary:** No.

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

### 8. **Fiscal implications:**

#### Administrative Costs

The Department of Taxation ("the Department") has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, the Department considers implementation of this bill as "routine," and does not require additional funding.

The Department will provide specific administrative costs on any legislation that is not "routine." Additionally, the Department will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, the Department will identify the costs at that time.

## Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2019. Such impact would exist only to the extent that military retirement income that is currently taxed by Virginia would become exempt from taxation as a result of this bill.

There are several forms of military retirement pay available to disabled veterans. Combat-Related Special Compensation ("CRSC") is not subject to federal or Virginia taxation. Concurrent Retirement and Disability Payments ("CRDP") are generally subject to both federal and Virginia taxation. See Line 11 for an explanation of these two programs. A military veteran may be entitled to additional military retirement income to the extent that his retirement pay exceeds his disability compensation, and such income is generally subject to taxation as well.

Based on the U.S. Department of Defense's Statistical Report on the Military Retirement System for Federal Fiscal Year 2016, 42,996 Virginia veterans received \$828.9 million in CRDP compensation. Such report does not provide specific data on the amount of such compensation paid to veterans with a VA rating of 100 percent. However, by using the percentage of 100 percent disabled veterans nationwide as a proxy, the Department estimates that approximately 8,137 Virginians are rated by the VA as 100 percent disabled and received approximately \$244.79 million in CRDP income during Federal Fiscal Year 2016.

This bill would limit the subtraction to only those taxpayers whose federal adjusted gross income does not exceed 250 percent of the federal poverty level for a four-person household. It is estimated that, in Federal Fiscal Year 2016, approximately 3,957 Virginians were rated by the VA as 100 percent disabled and also had federal adjusted gross income not in excess of 250 percent of the federal poverty level for a four-person household. Total CRDP compensation received by this group is estimated to be approximately \$109.32 million.

Exempting such CRDP income from Virginia taxation could have a revenue impact of approximately \$10.6 million in Fiscal Year 2019, \$8.3 million in Fiscal Year 2020, \$9.4 million in Fiscal Year 2021, \$10.8 million in Fiscal Year 2022, \$12.3 million in Fiscal Year 2023, and \$14.1 million in Fiscal Year 2024.

However, this estimate does not take into account qualifying Virginia National Guard veterans receiving retirement pay from the Commonwealth nor does it take into account military retirement pay other than CRDP compensation. To the extent that all military retirement pay received from the federal government is taken into account, the annual revenue impact could increase by as much as an additional \$2.7 million in the first year.

It is likely that the veterans who would claim the proposed subtraction qualify for the existing Virginia subtraction for up to \$20,000 of disability income or the \$12,000 Virginia age deduction. Accordingly, the veterans who would be entitled to claim this subtraction may already have a reduced tax liability because of other Virginia subtractions, thereby reducing the revenue impact.

**9. Specific agency or political subdivisions affected:**

Department of Taxation

**10. Technical amendment necessary: No.**

**11. Other comments:**

Federal Law

*Military Retirement Pay and Veterans Disability Compensation*

A military retiree (generally, a service member who serves 20 years or more in the military) typically qualifies for military retirement pay and certain other veterans benefits. The amount of military retirement pay a military retiree receives is based on a formula or scale that factors in the person's military rank at retirement and the person's length of military service. Military retirement pay is determined and paid by the U.S. Defense Finance and Accounting Service ("DFAS"). DFAS is an agency of the United States Department of Defense.

A disabled veteran may apply for disability compensation from the VA. The VA can approve veterans as eligible for veterans disability compensation for one or more documented service-connected injuries or illnesses that continue to affect the person's health or abilities following separation from the military. The VA calculates the amount to be paid to a veteran based on a formula that factors in the person's service-connected disability rating and the person's number of dependents. Service-connected disability ratings are made in 10 percent increments from 0 percent to 100 percent.

"Concurrent receipt" refers to a veteran's eligibility to receive both military retirement pay and VA disability compensation. Until 2004, concurrent receipt was prohibited by federal law, so a person receiving military retirement pay was required to waive some or all of that pay in order to receive VA disability compensation. This waiver of retirement pay for disability compensation would cause a dollar-for-dollar offset. As a result, a military retiree subject to the federal ban on concurrent receipt was limited to the higher of: (1) the person's military retirement pay; or (2) the person's veterans disability compensation, but not to the sum of the two.

Federal law was changed as of January 1, 2004, so that certain military retirees are eligible for full concurrent receipt of military retirement pay and veterans disability compensation. This is referred to as Concurrent Receipt of Retirement Pay and Disability Compensation ("CRDP"). To be eligible claimants for CRDP, a veteran must show that he or she has a service-connected disability and:

- Is a regular retiree with a VA disability rating of 50 percent or greater;
- Is a reserve retiree with 20 qualifying years of service, who has a VA disability rating of 50 percent or greater and who has reached retirement age. (In most cases the retirement age for reservists is 60, but certain reserve retirees may be eligible before they turn 60. If he or she is a member of the Ready Reserve, his or her

retirement age can be reduced below age 60 by three months for each 90 days of active service they have performed during a fiscal year.);

- Is retired under Temporary Early Retirement Act and have a VA disability rating of 50 percent or greater; or
- Is a disability retiree who earned entitlement to retired pay under any provision of law other than solely by disability, and they have a VA disability rating of 50 percent or greater.

CRDP was a "phase in" of benefits that gradually restored a military retiree's VA disability offset from January 2004 to January 2014. This meant that an eligible retiree's retirement pay gradually increased each year until the phase in was complete effective January 2014. Once the phase in was complete, eligible retirees received both halves—their military retirement pay and their disability compensation—automatically without being required to use a complicated phase-in formula.

While CRDP has helped some disabled military retirees, many retirees did not qualify because they had less than a 50 percent disability rating. Such retirees continued to be subject to the ban on concurrent receipt, which required them to reduce their retirement pay dollar-for-dollar by the amount of disability compensation they were receiving. In 2008, Congress enacted a program called Combat-Related Special Compensation ("CRSC"), which allows military retirees to receive monthly compensation to replace some or all of their VA disability offset, even if they do not have a disability rating of a 50 percent or more. To be eligible claimants for CRSC, a veteran must show that he or she has a combat-related disability and:

- Is entitled to and/or receiving military retired pay with 20 or more years of service;
- Is rated at least 10 percent disabled by the VA, or a disability directly related to a Purple Heart.

Military retirees cannot receive both CRSC and CRDP. If a retiree qualifies for both, DFAS will automatically apply the entitlement that is most advantageous to him or her. Every year, a military retiree has the opportunity to change his or her election.

### *Federal Taxation*

As a general rule, pension income is taxable. Therefore, military retirement pay received from DFAS that is based on age, length of service, or rank is taxable under federal law, regardless of whether a military retiree is disabled. CRDP payments received from DFAS are also taxable pursuant to federal law, because such payments are intended to recover the retirement pay that military retirees waive to receive VA disability compensation.

In contrast, federal law exempts from taxation certain benefit or compensation received under any law administered by the VA. VA disability compensation received from the VA by any veteran—including a military retiree—is exempt from taxation under federal law.

Federal law also exempts from taxation any pension income, annuities, or similar allowances for personal injuries or sickness resulting from active service in the armed forces of any country. Except for taxpayers who were entitled to receive pension income, annuities, or similar allowances for personal injuries or sickness on or before September 24, 1975, or who were members of the armed forces of any country (or a reserve component thereof) or under a binding written commitment to become such a member on September 24, 1975, such exemption is only allowed to the extent that:

- The taxpayer received such income by reason of a combat-related injury;
- The taxpayer would be entitled to receive disability compensation from the Department of Veterans Affairs if they applied; or
- The taxpayer received such income on account of personal physical injuries or physical sickness.

CRSC payments received from DFAS are exempt under federal law, because military retirees receive such payments by reason of their combat-related injuries. Military retirement pay received from DFAS that is based on a disability is not taxable to the extent that such pay meets one of the tests above.

Military retirement pay received from DFAS based on disability is generally taxable unless the taxpayer received such income by reason of a combat-related injury; the taxpayer would be entitled to receive disability compensation from the Department of Veterans Affairs if he applied; or the taxpayer received such income on account of personal physical injuries or physical sickness.

These rules are illustrated in the chart below.

<b>Military Income</b>	<b>Taxable</b>	<b>Tax-Exempt</b>
Military Retirement Pay Received from DFAS Based on Age, Length of Service, and/or Rank	X	
Military Retirement Pay Received from DFAS Based on Disability	X	
Disability Compensation Received from the VA		X
CRDP Payments Received from DFAS	X	
CRSC Payments Received from DFAS		X

### Other States

At least 34 states offer some form of tax benefit to taxpayers receiving military retirement compensation, and these states generally do not limit such tax benefits to taxpayers with a military 100 percent service-connected disability. Of these jurisdictions, 14 states (Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, Missouri, New Jersey, New York, Ohio, Pennsylvania, and Wisconsin) exempt military

retirement compensation from personal income tax, although this number includes states that provide benefits for a broad range of retirement income. The remaining 21 states allow taxpayers to exclude a specified amount of military retirement compensation from their income.

Of the jurisdictions surrounding Virginia, Maryland offer exemptions ranging from \$5,000 for those under age 65 to \$10,000 for those ages 65 or older. North Carolina offers a full exemption for retirees with five years of service as of August 12, 1989. In addition, Kentucky and West Virginia offer exemptions of \$41,110 and \$20,000, respectively.

### Virginia Military Tax Preferences

Since the starting point for determining an individual's Virginia income tax is federal adjusted gross income, any income exempt for federal income tax purposes is generally exempt for Virginia income tax purposes.

In addition, taxpayers may subtract the following military-related items for the purposes of computing Virginia taxable income:

- Wages or salaries received for service in the Virginia National Guard, not exceeding income for thirty-nine days of service or \$3,000, whichever is less. This subtraction only applies to persons in the ranks of O3 and below.
- All military pay and allowances earned while serving in a combat zone or qualified hazardous duty area, to the extent they were included in federal adjusted gross income.
- \$15,000 of military basic pay for military personnel on extended active duty for periods in excess of ninety days. The subtraction amount is reduced dollar-for-dollar by the amount which the taxpayer's military basic pay exceeds \$15,000 and will be reduced to zero if such pay is equal to or exceeds \$30,000.
- Any amount received as military retirement income by an individual awarded the Congressional Medal of Honor.
- The amount of military death gratuity payments received after September 11, 2001, by survivors of military personnel who are killed in the line of duty. This subtraction amount must be reduced dollar-for-dollar by the amount that is allowed as an exclusion from federal adjusted gross income to the survivor on his or her federal income tax return.

For taxable years beginning on or after January 1, 2011, Virginia exempts from taxation the real property, including the joint real property of a husband and wife, and the land, not exceeding one acre, upon which the real property is situated of any military veteran who has been rated by the VA to have a 100 percent service-connected, permanent, and total disability, and who occupies the real property as his or her principal place of residence. The surviving spouse of a veteran may also qualify for this exemption, so long as the following conditions are met: the veteran's death occurred on or after January 1, 2011; the

surviving spouse does not remarry; and the surviving spouse continues to occupy such real property as his or her principal place of residence.

### Virginia's Age and Disability Tax Preferences

Taxpayers age 65 and older may claim an additional \$800 personal exemption. Certain taxpayers may also qualify for an age deduction of up to \$12,000. For taxpayers born on or before January 1, 1939, the amount of the age deduction is \$12,000. For taxpayers born after January 1, 1939, who have attained the age of 65, the amount of the age deduction is means-tested. Accordingly, the \$12,000 age deduction is reduced dollar-for-dollar for single taxpayers whose income exceeds \$50,000 and for married taxpayers whose combined income exceeds \$75,000.

Taxpayers who are totally and permanently disabled may exclude up to \$20,000 of disability income, as defined under federal law, in calculating Virginia taxable income. Taxpayers may claim either an age deduction or a disability deduction, but not both.

### Proposed Legislation

This bill would allow an individual income tax subtraction for the amount of annual retirement compensation received for service as a member of the United States Armed Forces or the Virginia National Guard by a veteran who has been determined by the VA or its successor agency pursuant to federal law to have a 100 percent service-connected disability. This bill would limit the subtraction to only those taxpayers whose federal adjusted gross income does not exceed 250 percent of the federal poverty level for a four-person household. The bill would also provide that no subtraction would be permitted to the extent that another Virginia subtraction or deduction for annual retirement compensation for such service has been claimed.

This bill would be effective for taxable years beginning on or after January 1, 2018.

### Similar Bills

**House Bill 792** is identical to this bill, except that it would limit the subtraction to only those taxpayers whose service-connected disability is permanent and total and whose federal adjusted gross income does not exceed 150 percent of the federal poverty level for a four-person household.

**Senate Bill 480** would provide a subtraction from Virginia taxable income for military retirement income.

cc : Secretary of Finance

Date: 1/28/2018 RWC  
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