OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of:	OTA Case Nos. 18011725 & 18011727
GREGORIO Z. UY AND JOYLYN Y. UY	Date Issued: January 2, 2019

OPINION

Representing the Parties:

For Appellants: Chris Donis, TAAP[1]

For Respondent: Judy F. Hirano, Tax Counsel IV

For the Office of Tax Appeals: William J. Stafford, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to California Revenue and Taxation Code section 19324(a),[2] Gregorio Z. Uy and Joylyn Y. Uy (appellants) appeal an action by the Franchise Tax Board (FTB or respondent) in denying appellants' claims for refund of $970 and $1,069, plus interest, for the 2012 and 2013 tax years, respectively.[3]

Appellants waived their right to an oral hearing, and therefore this matter is being decided based on the written record.

ISSUE

Whether appellants are entitled to exclude from their taxable income a portion of their military retirement income for the 2012 and 2013 tax years.

[1] Appellants filed their opening briefs on their own behalf. Subsequent representation was provided by the Tax Appeals Assistance Program (TAAP).

[2] Unless otherwise indicated, all statutory references are to sections of the California Revenue and Taxation Code for the tax years at issue.

[3] On appeal, appellants now state that due to calculation errors, they are only entitled to reduced refunds of $397 and $362 for the 2012 and 2013 tax years, respectively. Appellants, however, have not provided calculations showing how they arrived at these revised refund amounts.

FACTUAL FINDINGS

1. Gregorio Z. Uy (appellant-husband), a decorated veteran of the U.S. Navy, was honorably discharged in 1998. Thereafter, he started receiving taxable military retirement pay (i.e., pension income) from the U.S. Department of Defense (DOD) based on his years of service. This taxable income was reported on Internal Revenue Service (IRS) Form 1099-R.
2. In addition to the taxable military retirement pay received from the DOD, appellant-husband applied for and received nontaxable service-connected disability compensation from the U.S. Department of Veterans Affairs (VA).
3. As relevant here, in three separate VA award letters, the VA granted appellant-husband retroactive rating increases that included the tax years at issue. Thus, on June 23, 2014, October 29, 2015, and June 28, 2017, the VA increased appellant-husband's then-existing rating to 80 percent, to 90 percent, and then to 100 percent, respectively. Each of these increases were effective September 18, 2009, and were therefore retroactive.[4]
4. Because appellant-husband's VA disability rating was over 50 percent, he was eligible for additional DOD military retirement pay known as Concurrent Retirement and Disability Pay (CRDP), discussed more fully in the next section. Based on the record, it appears appellant-husband has received CRDP since at least 2011, because at that time, he had a 70 percent VA rating.
5. On June 26, 2014, just three days after the issuance of the June 23, 2014 VA award letter, appellant-husband acknowledged receiving a retroactive lump-sum payment from the VA.[5] Appellant-husband states he "understands [this lump-sum payment] to include amounts attributable to CRDP and amounts attributable to otherwise uncompensated [d]isability [b]enefits from the retroactive period of the [June 23, 2014 VA award letter]."[6]

[4] The three VA award letters indicated the retroactive changes for the 2012 and 2013 tax years included cost-of-living adjustments, in addition to increases based on findings in the letters.

[5] This retroactive lump-sum amount was $13,893.21.

[6] Information was not provided as to whether appellant-husband received retroactive lump-sum payments consisting of CRDP and VA disability payments following the October 29, 2015 and June 28, 2017 VA award letters.

6. The three VA awards indicate that the VA paid to appellant-husband nontaxable VA disability compensation for the retroactive award period, effective September 18, 2009, which included the 2012 and 2013 tax years. Thus, the letters indicate these payments have been paid to him in full, and without withholdings of federal or California income taxes.
7. On their joint 2012 and 2013 California resident income tax returns, appellants reported as taxable all of their DOD military retirement pay of $12,726 and $12,964 for the 2012 and 2013 tax years, respectively. These amounts were reported on Form 1099-R.
8. Subsequently, appellants filed amended returns for the 2012 and 2013 tax years. Based on the June 23, 2014 retroactive rating increase (discussed above), appellants excluded from their California gross income the entire military retirement pay reported on Forms 1099-R for the 2012 and 2013 tax years, contending it was attributable to the nontaxable VA disability payments. Appellants requested refunds in the amounts of $397 and $362, plus interest, for the 2012 and 2013 tax years, respectively.
9. On February 26, 2015, respondent denied appellants' 2012 and 2013 claims for refund. These timely consolidated appeals followed.

DISCUSSION

To be entitled to a refund, appellants must establish that their amended tax returns show the correct total amount of tax. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.) A taxpayer who claims a deduction or exclusion has the burden of proving by competent evidence that he or she is entitled to such. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) Furthermore, taxpayers have the burden of establishing entitlement to exclude their military retirement income as disability compensation. (*Appeal of Arthur L. and Bertha Huber*, 82-SBE-222, Sept. 21, 1982;[7] *Holt v. Commissioner* (1999) 78 T.C.M. (CCH) 625.)

[7] Board of Equalization (BOE) opinions are generally available for viewing on its website: <http://www.boe.ca.gov/legal/legalopcont.htm#boeopinion>.

California residents are subject to tax on their entire taxable income. (§ 17041(a)(1).) Section 17071 incorporates by reference Internal Revenue Code (IRC) section 61(a)(11),[8] which includes pension income in gross income. U.S. military retirement income paid by the DOD constitutes gross income, unless otherwise excluded by law. (*Wheeler v. Commissioner* (2006) 127 T.C. 200, 205, fn. 11.) Retirement pay for the length of military service is not exempt from taxation, regardless of the existence of a VA disability determination. (*Holt v. Commissioner*, *supra*, 78 T.C.M. (CCH) 625.) Further, under certain circumstances, taxpayers are allowed to exclude from gross income their pension income received for personal injuries or sickness resulting from active service in the armed forces. (§ 17131; IRC, § 104(a)(4).)

Unlike military retirement pay, service-connected disability compensation paid by the VA is not included in taxable income or reported on Form 1099-R, and is exempt from federal and state taxes. (IRC, § 140(a)(3); 38 U.S.C. § 5301(a)(1).) To receive both taxable military pension income from the DOD and nontaxable disability benefits from the VA, military retirees, such as appellant-husband, are required to waive receipt of part of their military pension equal to the amount of the VA benefits they receive. (38 U.S.C. §§ 5304, 5305.) This waiver is known as a "VA waiver."[9]

The effect of the waiver is that military retirees are entitled to receive the same amount of income as they would have received under the taxable military retirement payments, but are allowed to exclude from taxable income an amount equal to the VA waiver amount. To accomplish this, the VA assigns a service-connected disability rating percentage that is used to compute nontaxable disability benefits, which is then, in simple terms, substituted for taxable military retirement income based on the VA waiver amount. This rating percentage can be increased retroactively, which may allow a military retiree to convert a portion of previously received, taxable military retirement pay into nontaxable VA disability pay.

On appeal, appellants contend they can exclude from their California gross income the portion of appellant-husband's military retirement pay equal to the retroactive increases to his

[8] For the 2012 and 2013 tax years, section 17024.5(a)(1)(O) provides that for Personal Income Tax Law purposes, California conforms to the IRC as of a January 1, 2009, specified date. Thus, references herein to the IRC are to the version in effect on January 1, 2009. Further, it is well settled that where federal law and California law are the same, federal rulings and regulations dealing with the IRC are persuasive authority in interpreting the applicable California statute. (See *J. H. McKnight Ranch v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, fn.1.)

[9] A copy of appellant-husband's VA waiver is not located in the appeal record. However, it appears his VA waiver was in existence well before the tax years at issue.

VA disability benefits. Appellants principally rely on *Strickland v. Commissioner* (4th Cir. 1976) 540 F.2d 1196 (*Strickland*) and IRC sections 104(a) and (b). We reject appellants' contentions for the following reasons.

First, military retirement pay issued by the DOD is separate and distinct from VA disability pay, and therefore is based on different criteria and standards. (*Appeal of Arthur L. and Bertha Huber, supra*; *Burkins v. United States* (10th Cir. 1997) 112 F.3d 444, 447.) Military retirement pay is includible in taxable income regardless of the existence of a VA disability determination. (*Holt v. Commissioner, supra,* 78 T.C.M. (CCH) 625.) However, although VA disability pay is nontaxable, appellants cannot substitute it for taxable military retirement pay from the DOD to achieve an exclusion from gross income.

Here, for the 2012 tax year, appellants excluded the entire $12,726 military retirement payment from gross income because appellant-husband apparently received retroactive VA disability payments for that tax year that exceeded the $12,726.[10] Similarly, for the 2013 tax year, appellants excluded the entire $12,964 military retirement payment from gross income because appellant-husband apparently received retroactive VA disability payments for that tax year that exceeded the $12,964.[11] The record indicates that the VA did *not* withhold payment[12] of any part of the increased, retroactive VA disability compensation that appellants received for the 2012 and 2013 tax years. Rather, the VA actually paid the disability awards to appellants in tax years *after* 2012 and 2013, when they received this money tax-free. In other words, appellants did not receive or report as taxable these disability payments in either 2012 or 2013. Instead, when the VA paid the retroactive benefits subsequent to 2012 and 2013, the VA did not withhold payment, and it appears the VA actually paid these amounts, which were not subject to federal or California income taxes. Consequently, there was no need for them to amend their 2012 and 2013 California returns to exclude the tax-exempt income a second time. By amending

[10] Specifically, for the 2012 tax year, the 2014 VA award letter showed annual, retroactive VA disability payments totaling $23,443. Because this amount exceeded appellant-husband's $12,726 of taxable military retirement pay by $10,717, appellants excluded the entire $12,726 from their California gross income.

[11] Similar to the 2012 tax year, for the 2013 tax year, the 2014 VA award letter showed annual, retroactive VA disability payments totaling $23,815.56. Because this amount exceeded appellant-husband's $12,964 of taxable military retirement pay by $10,851.56, appellants excluded the entire $12,964 from their California gross income.

[12] When using the term "withhold," we are not referring to federal or California income tax withholding. Rather, we are simply referring to the fact that the VA paid disability compensation to appellant-husband and therefore did not retain or keep that compensation from him.

their returns, appellants were effectively seeking to claim a double exemption from gross income. On this basis, respondent properly denied appellants' claims for refund.

Second, appellants' reliance on *Strickland* is misplaced. In *Strickland*, the Fourth Circuit addressed the effect of a retroactive disability determination made by the VA on the taxpayer's ability to exclude from his taxable income certain military retirement income received during the retroactive period. The court found that a VA waiver form filed by the taxpayer before the retroactive disability rating increase was granted by the VA could still entitle a taxpayer to the benefit of the VA waiver back to the effective date of the retroactive rating increase. (See also IRS Rev. Rul. 78-161, 1978-1 C.B. 31.) In short, if the taxpayer filed a proper form requesting a VA waiver, the rule in *Strickland* would essentially allow the taxpayer to act as if part of his or her military retirement payments received from the DOD in a previous year was waived and instead received from the VA, equal to his or her retroactive increase in VA disability pay.

However, the factual situation in *Strickland* does not apply here. For a taxpayer to be allowed a tax exclusion as contemplated in *Strickland*, there must be a retroactive VA disability rating change that includes the tax years at issue, *and* the taxpayer must not otherwise be afforded the benefit of such retroactive increase. Here, while there has been a VA disability rating change retroactive to the 2012 and 2013 tax years, appellant-husband has already been afforded the benefit, which negates the need to file amended returns. Specifically, the VA did *not* withhold payment of any part of the increased nontaxable VA disability compensation, as set forth in the three award letters dated June 23, 2014, October 29, 2015, and June 28, 2017.

Third, because appellant-husband received a retroactive lump-sum payment that included both Concurrent Retirement and Disability Pay (referred to above and hereinafter as CRDP) and VA disability payments, it appears he effectively received the benefit of the retroactive VA rating increases without having to amend his returns. In general, taxpayers are not allowed to receive both military retirement payments and VA disability payments in the same year. (38 U.S.C. § 5304.) However, as relevant here, one exception is CRDP, which is applicable for retired servicemembers, such as appellant-husband, for years they have a VA disability rating of 50 percent or higher. (10 U.S.C. § 1414.) This exception was created in 2004 and included a "phase-in" period extending through the end of 2013. (10 U.S.C. § 1414(c).) CRDP increases the retirement payments received by qualifying servicemembers by allowing them to receive military retirement pay that would otherwise be waived at the same time they receive VA

disability payments. Thus, CRDP increases the total amount of payments received and represents an exception to the general rule that retirement pay is waived to the extent of disability payments. Because CRDP represents retirement payments, CRDP payments are taxable.[13]

Here, appellant-husband acknowledges receiving lump-sum payments consisting of both CRDP and VA disability payments that are retroactive to the tax years at issue. For example, on June 26, 2014, appellant-husband received a $13,893.21 lump-sum payment from the VA, which he "understands to include amounts attributable to CRDP and amounts attributable to otherwise uncompensated [d]isability [b]enefits from the retroactive period of the [June 23, 2014 VA award letter]." Therefore, because these retroactive payments included nontaxable VA disability payments, it appears appellant-husband received full restoration of the VA disability payment increase that was retroactive to the 2012 and 2013 tax years.

To be sure, simply receiving CRDP in a given year, whether as a current or retroactive payment, does not necessarily fix the problem caused by a retroactive VA disability payment increase. In such circumstances, it may be appropriate under *Strickland* to file an amended return to convert otherwise taxable military income into nontaxable VA disability income. However, here, the VA and DOD appear to have worked together to provide an administrative remedy to this problem because appellant-husband was granted lump-sum, retroactive CRDP payments that included, at least in part, nontaxable VA disability pay, which was paid to appellant-husband after the tax years at issue and *without* withholding such payments from appellants. Appellants have not presented argument or evidence showing otherwise, or that this was not also the case with respect to retroactive CRDP and VA disability payments for the two subsequent VA award letters issued on October 29, 2015, and June 28, 2017.[14] Accordingly, appellants are not entitled to receive a double exemption from their taxable income.

Fourth, appellants are not entitled to exclude any portion of their military retirement pay from gross income because the requirements of IRC section 104(a)(4) and (b)(2) are not met. IRC section 104(a)(4) provides, in part, that gross income does not include "amounts received as

[13] Military retirees qualifying for CRDP must generally still have affirmatively waived a portion of their military retirement income during the phase-in period, but are then entitled to the CRDP to replace the waived military retirement pay, or a portion thereof.

[14] Unlike a retroactive increase in the VA disability rating, which only increases the portion of previously received payments treated as exempt from tax, the retroactive increase in CRDP equates to additional payments owed to appellant-husband. However, these retroactive CRDP payments are taxable in nature, and therefore the tax on those payments cannot be refunded to appellants here.

a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces . . . ." To claim the exclusion, a servicemember must have retired due to disability and received a disability rating from the applicable military branch with the DOD, *not* the VA. (See *Williams v. United States* (Ct. Cl. 1969) 405 F.2d 890, 891-892; *Holt v. Commissioner*, *supra*, 78 T.C.M. (CCH) 625; *Appeal of Arthur L. and Bertha Huber*, *supra*.) Here, the evidence clearly shows, and appellant-husband admits, that he retired from the military based on years of service, not disability. Therefore, while appellants have properly excluded their VA disability compensation from gross income, they cannot similarly exclude their military retirement pay from the DOD because appellant-husband did not retire due to disability. Accordingly, IRC section 104(a)(4) is inapplicable.

Appellants contend that because they meet one or more of the requirements in IRC sections 104(b)(2) and (b)(4), they are entitled to exclude the military retirement pay. However, IRC section 104(b) provides no independent basis for exclusion. Instead, it limits the classes of persons who otherwise might be eligible for the IRC section 104(a) exclusion. (*Reimels v. Commissioner* (2004) 123 T.C. 245, 255-256.) Therefore, from the outset, to be able to exclude portions of their military retirement income, appellants must meet the requirements of IRC section 104(a)(4), and then also meet one of the four requirements listed in IRC section 104(b). Since, as discussed above, IRC section 104(a)(4) does not apply to the facts of the present appeal, then by extension, IRC section 104(b) does not apply.[15]

Finally, appellants also contend that they are entitled to a California refund because the IRS granted a refund based on the same adjustment for the 2013 tax year. However, the record contains no evidence that the IRS granted the refund based on an audit of the return or determined the income in question was nontaxable. Even if the IRS had granted a refund for the tax years at issue, we are not bound to follow an IRS determination when the facts show it was in

[15] Appellants also reference IRS Publication 525 to support their position. However, for the same reasons described above, appellants do not meet the fact patterns as provided in that publication.

error. (*Appeal of Der Wienerschnitzel International, Inc.*, 79-SBE-063, Apr. 10, 1979.) Accordingly, appellants have not shown they are entitled to the claimed refunds.[16]

HOLDING

Appellants have failed to demonstrate they are entitled to exclude from their taxable income a portion of their military retirement income for the 2012 and 2013 tax years.

DISPOSITION

Respondent's action in denying appellants' claims for refund is sustained.

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

DocuSigned by:
Neil Robinson
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Neil Robinson
Administrative Law Judge

[16] Appellants also allege that respondent never reviewed their refund claims prior to respondent's denial, and, therefore, ask us to overturn respondent's determination on equitable grounds and/or grounds that respondent's actions amount to a denial of due process. Our authority, however, is limited to determining the correct amount of tax for the years on appeal. As such, except for certain circumstances not present here, we have no power to remedy respondent's actual or alleged violation of any substantive or procedural right. (Cal. Code of Regs., tit. 18, § 30102(b)(5).) In any event, through this appeal, we note that due process is being satisfied. (See *Appeals of Walter R. Bailey*, 92-SBE-001, Feb. 20, 1992.)