

**PART FIVE
TAXATION**

CHAPTER 1

COMPUTATION OF WAGES SUBJECT TO FEDERAL INCOME TAX WITHHOLDING

50101. Background

Federal income tax withholding (FITW) is based on payments actually or constructively paid, regardless of date on which they are earned. Retired pay is constructively paid when it is credited to the account or set apart for a retiree so that the member may draw on it at any time, although it is not actually reduced to possession. It must have been credited to or set apart for the retiree without any substantial limitation or restriction as to the time or manner of payment or condition under which it is to be made and brought within the retiree's control and disposition.

50102. Retired Pay Subject to FITW

Except as otherwise indicated in this chapter, retired pay is income and constitutes wages subject to FITW.

50103. Retired Pay Not Subject to FITW

The gross retired pay of a member is not subject to FITW if the member's retired pay is computed only on the basis of percentage of disability and the member is on the temporary or permanent disability retired lists, if:

- a. On or before 24 Sep 1975, the member was entitled to receive retired pay computed on the basis of percentage of disability (26 U.S.C. 104(a)(4) and 104(b)(2)(A)); or
- b. On 24 Sep 1975, he or she was a member of the Armed Forces (or Reserve component thereof) or under a binding written commitment to become such a member (26 U.S.C. 104(a)(4) and 104(b)(2)(B)); or
- c. The member receives disability retired pay because of a combat-related injury. The term combat-related injury means personal injury or sickness incurred as a direct result of armed conflict, or while engaged in extra hazardous service, or under conditions simulating war, or caused by an instrument of war.

50104. Effect of VA Award on Federal Income Tax Withholding

A member is entitled to exclude from the taxable portion of retired pay:

- a. The maximum amount that he/she would be entitled to receive as disability compensation upon application to the VA;
- b. An additional amount based on the difference between a prospective Department of Veterans Affairs disability compensation award and the amount excluded under paragraph 50103.
- c. The retroactive amount of a VA disability compensation award not previously excluded from retired pay.

50105. Gross Pay Partially Taxable

Part of the retired pay for members who are entitled to have their retired pay computed on the basis of both percentage of disability and years of service may be designated as FITW wages. Any reduction of FITW wages for disability retired pay must meet one of the conditions set forth in paragraph 50103.

- a. Compute FITW wages for members retired for disability on or after 1 Oct 1949:

- (1) If the member is placed on the Permanent Disability Retired List (PDRL), subtract retired pay based on the percentage of disability from retired pay based on the years of service. The result of such subtraction is FITW wages.

- (2) If the member is placed on the Temporary Disability Retired List (TDRL), use one of these two methods:

- (a) If the member's disability rating is 50 percent or more, compute as in a(1) above.

- (b) If the member's disability rating is less than 50 percent and retired pay is computed based on years of service, exclude from FITW wages the amount of retired pay the member would have received if such pay were computed solely on the actual percentage of disability. If the member's disability rating is less than 50 percent and the member elects to receive disability retired pay, based on the percentage of disability, the retired pay received is not FITW wages.

- b. FITW wages for members retired before 1 Oct 1949, fell into two categories. Their retired pay was based on years of service and was fully taxable, or it was based on disability and was

nontaxable. Members retired for physical disability before 1 Oct 1949, were assigned a disability rating for purposes of computing retired pay entitlement under the provisions of the Career Compensation Act. These members could continue to receive the nontaxable retired pay they were receiving on 30 Sep 1949, or could elect to receive retired pay computed under the provisions of the Career Compensation Act based on the percentage of disability assigned or years of active service. If they chose to have their pay computed based on the Career Compensation Act, their FITW wages were computed as described in paragraph 50103 or subparagraph 50105a(l).

50106. FITW Wage Reductions From Deductions and Collections

Deductions and collections which reduce FITW wages include:

a. The total reduction of a member's retired pay in order to participate in the Retired Serviceman's Family Protection Plan (RSFPP). This deduction did not reduce taxable income until the tax laws were changed to permit a dollar-for-dollar reduction effective 1 Jan 1966. The tax implication for a member who pays for this protection by direct remittance is discussed in paragraph 50111.

b. The total reduction of a member's retired pay to participate in the Survivor Benefit Plan (SBP). The tax implication for a member who pays for this protection by direct remittance is discussed in paragraph 50110.

c. Waiver of pay because a member is receiving compensation or a pension from the Department of Veterans Affairs.

(1) If the member's gross retired pay is fully subject to FITW, subtract the amount of the VA waiver from FITW wages.

(2) In the case of a member retired because of physical disability, reduce FITW wages, if any, by the amount of the VA waiver or the portion of the member's retired pay based on the actual percentage of disability, whichever is greater.

d. Reduction of retired pay due to the Dual Compensation Act of 1964:

(1) Reduce the FITW wages of a nondisability retiree by the amount of retired pay forfeited because of the retired member's Federal Civil Service employment.

(2) Determine the FITW wages of a member retired with a disability:

(a) Step A. Gross retired pay less amount of RSFPP and/or SBP deduction and less amount of disability retired pay or VA disability compensation (whichever is greater) equals amount of FITW wages if there is no Dual Compensation Act deduction. If there is a Dual Compensation Act deduction, use the formula in step B in computing the amount of FITW wages.

(b) Step B. Gross retired pay less amounts of RSFPP and/or SBP deduction and less amount of retired pay waived to receive VA compensation equals amount of adjusted gross pay.

(c) Step C. Taxable pay from step A, divided by adjusted gross retired pay from step B equals percentage ratio. Carry to five decimal places and round to four decimal places.

(d) Step D. Subtract the amount of retired pay forfeiture for Federal civilian employment from the adjusted gross pay obtained in step B. Multiply the resulting figure by the percentage ratio from step C to obtain FITW wages.

50107. United States Citizens Abroad

Retired pay of members who are physically present or reside in a foreign country is subject to FITW as if they resided in the United States or territories over which it exercises sovereignty. Thus, the withholding rules discussed above apply.

50108. Arrears of Pay

See part seven, chapter 1, section C, for taxation policies that apply to the deceased member and that member's beneficiaries.

50109. Collection of Delinquent Taxes

a. **Voluntary Withholding.** A retired member may, with the consent of IRS, have deductions made from his or her retired pay to satisfy such a debt. The T allotment has been designated to allow a member to make payments to IRS in this manner. See part four, chapter 4.

b. **Involuntary Withholding.** If a member who is receiving retired pay neglects or refuses to pay his or her Federal income tax liability within 10 days of receiving notice of liability, the District Director of the member's local IRS office can collect the amount by placing a levy on the member's retired pay. IRS is required to give the member 10 days notice that a levy will be executed. This notice is normally included with the notification of liability. See part six, chapter 2.

50110. Taxability of Direct Remittance Payments for Coverage Under the Survivor Benefit Plan (SBP)

a. When the account of an SBP participant is placed in a suspended status and the member is required to pay monthly SBP costs by remittance, a certificate of costs is furnished at the end of the calendar year in which the account was suspended, if, in that year, the member had received FITW wages. The certificate of costs shows the amount of SBP costs paid by direct remittances during that year for the member's use in filing a Federal income tax return for that year; that is, the amount shown on the certificate may be applied to reduce the FITW wages shown on the TD Form W-2P issued by the retired pay activity.

b. A certificate of costs is not issued to cover deposits made in later years. During those years the member will have received no taxable retired pay against which it could be applied. If in the future the member again becomes entitled to receive retired pay, a certificate of costs is issued at the time the pay account is reinstated, covering all deposits made during years of suspension and not previously included on a certificate of costs. If the member does not again receive retired pay before death and, as a result, the retired pay income exclusion for SBP costs is not fully used during the member's lifetime, the remaining income exclusion (the unused "consideration for the contract") is available to the annuitant for purposes of reducing taxable income derived from annuity payments. In such cases, therefore, at the time the annuity is established, the annuitant is furnished a certificate of costs covering pertinent deposits made. See part nine, chapter 11.

50111. Taxability of Direct Remittance Payments for Coverage Under the Retired Serviceman's Family Protection Plan (RSFPP)

The policy shown for the Survivor Benefit Plan in paragraph 50110 applies to members who paid RSFPP coverage by direct remittance after 1 Jan 1966. Note that certificates of costs were issued to all members whose accounts were active as of 31 Dec 1965. These certificates covered costs that were paid by direct remittance and automatically deducted from the members retired pay.

50112 Processing Correction of Records Cases
If payment is made as the result of the correction, that payment is processed:

a. When amounts previously paid and reported as FITW wages are not subject to FITW as a result of the correction, the member is provided either a corrected TD Form W-2P for the 3 calendar years before the year that the correction action is made or a letter citing the before and after amounts for each calendar year involved. The member may then obtain a tax refund, if any is due, from IRS based on that member's total tax liability for 3 years. If the member desires a refund for periods before this 3-year period, a claim must be filed with the retired pay activity. That activity may use 52 Comp Gen 420 as a precedent for refunding excess FITW before this 3-year period.

b. When the member's retired pay is subject to FITW, the payment is reported as FITW wages from applicable current year appropriations reserved for such payment.

50113. Taxability and Withholding

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

(1) On 24 Sep 1975, the individual was either a member of an armed force 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 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; or

(3) The member would be entitled to receive disability compensation by the Department of Veterans Affairs (VA) for the same illness or injury which caused the member's entitlement if he/she applied for it.

b. **VA Compensation Awarded Prior to Separation.** Finance offices will not withhold taxes if, before separation, the member provides documentation that he/she is entitled to disability compensation from the VA per paragraph a(3) above.

c. **VA Compensation Awarded After Separation.** When a VA disability compensation award has not been made by the separation date, the commander should advise the member that a VA compensation award after separation could make the disability severance pay non-taxable. The member should also be advised to file appropriate tax returns, with VA provided documentation and related separation documents, claiming reduction in taxable income based on the St.Clair v. U.S. district court decision. A corrected IRS Form W-2 (W-2c) or other document which

could support the decrease in taxable income will not be issued.

50114. Taxability of Retired Pay for Fleet Reservist/Fleet Marine Corps Reservists Not Physically Qualified for Retention in the Fleet Reserve/Fleet Marine Corps Reserve

The retired pay of a member of the FR/FMCR transferred to the retired list when found not physically qualified for retention in the FR/FMCR, as stated in subparagraph 10201b, is subject to FITW.