

## CHAPTER 24

**COMPUTATION OF WAGES SUBJECT TO  
FEDERAL INCOME TAX WITHHOLDING**2401 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 paid constructively when it is credited to the account or set apart for a retiree so that he or she 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.

2402 RETIRED PAY SUBJECT TO FITW

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

2403 RETIRED PAY NOT SUBJECT TO FITW

240301. 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 September 24, 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)) (reference (dw)); or

B. On September 24, 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) (reference (dw))); 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.

2404 EFFECT OF VA AWARD ON FEDERAL INCOME TAX WITHHOLDING

240401. A member is entitled to exclude from the taxable portion of retired pay:

A. The maximum amount that he or she would be entitled to receive as disability compensation upon application to the Department of Veterans Affairs (VA);

B. An additional amount based on the difference between a prospective VA disability compensation award and the amount excluded under section 2403, above.

C. The retroactive amount of a VA disability compensation award not previously excluded from retired pay.

#### 2405 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 section 2403, above.

240501. Compute the FITW wages of members retired for disability on or after October 1, 1949, as follows:

A. 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.

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

1. If the member's disability rating is 50 percent or more, compute as in subparagraph 240501A., above.

2. 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.

240502. FITW wages for members who retired before October 1, 1949, fell into two categories. Such retired pay either 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 October 1, 1949 were assigned a disability rating for purposes of computing retired pay entitlement under the provisions of the Career Compensation Act (reference (w)). These members could either continue to receive the nontaxable retired pay they were receiving on September 30, 1949, or elect to receive retired pay computed under the provisions of the Career Compensation Act (reference (w)) based on the percentage of disability assigned or years of active service. If members chose to have their pay computed based on the Career Compensation Act (reference (w)), their FITW wages were computed as described in section 2403 or subparagraph 240501.A., above.

#### 2406 FITW WAGE REDUCTIONS FROM DEDUCTIONS AND COLLECTIONS

240601. Deductions and collections that 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 January 1, 1966. The tax implication for a member who pays for this protection by direct remittance is discussed in section 2411, below.

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 section 2410, below.

C. Waiver of pay because a member is receiving compensation or a pension from the VA.

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 (reference (at)):

1. Reduce the FITW wages of a non-disability 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 using the following process:

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 (reference (at)) deduction. If there is a deduction due to the Dual Compensation Act (reference (at)), use the formula in Step B to compute the amount of FITW wages.

b. Step B. Gross retired pay, less amounts of RSFPP and/or SBP deduction and less any amount of retired pay waived to receive VA compensation, equals the 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.

#### 2407 UNITED STATES CITIZENS ABROAD

The retired pay of members who temporarily or permanently reside in a foreign country is subject to FITW as if they resided in the United States or its possessions. Thus, apply the withholding rules discussed above.

#### 2408 ARREARS OF PAY

See section 3003 of this volume, for taxation policies that apply to deceased members and their beneficiaries.

#### 2409 COLLECTION OF DELINQUENT TAXES

240901. Voluntary Withholding. A retiree may, with the consent of the IRS, have deductions made from his or her retired pay to satisfy a debt due to tax delinquency. The class T allotment has been designated to allow a member to make payments to IRS in this manner. See [Chapter 22](#) of this volume.

240902. Involuntary Withholding. If a retiree neglects or refuses to pay his or her federal income tax liability within 10 days after receiving notice of liability, the cognizant IRS District Director can collect the amount by placing a levy on the member's retired pay. The IRS is required to give the member 10 days notice that a levy will be executed. This notice normally is included with the notification of liability. See [Chapter 28](#) of this volume.

#### 2410 TAXABILITY OF DIRECT REMITTANCE PAYMENTS FOR COVERAGE UNDER THE SURVIVOR BENEFIT PLAN (SBP)

★241001. When the retired pay account of an SBP participant is placed in a suspended status, the retiree is required to pay monthly SBP costs by remittance. (See section 5203 of this volume for resulting tax consequences.)

241002. 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 the certificate 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 [Chapter 52](#) of this volume.

2411 TAXABILITY OF DIRECT REMITTANCE PAYMENTS FOR COVERAGE UNDER THE RETIRED SERVICEMAN'S FAMILY PROTECTION PLAN (RSFPP)

The SBP rules in section 2410, above, apply to members who paid RSFPP coverage by direct remittance after January 1, 1966. Note that certificates of costs were issued to all members whose accounts were active as of December 31, 1965. These certificates covered costs that were paid by direct remittance and automatically deducted from the member's retired pay.

2412 PROCESSING CORRECTION OF RECORDS CASES

241201. If payment is made as the result of a correction of military records, that payment is processed as follows.

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 then may obtain a tax refund, if any is due, from the IRS based on his or her total tax liability for 3 years. If the retiree asks for 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 (reference (dx)) as authority 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.

2413 TAXABILITY AND WITHHOLDING

241301. General. Disability severance pay normally is taxable income. However, disability severance pay is not subject to tax withholding or reporting if at least one of the following three conditions exists:

A. On September 24, 1975, the individual either was a member of an Armed Force or was under a binding written commitment to become a member;

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

1. Directly from armed conflict,
2. While actually performing extra-hazardous service, even if the service does not directly involve combat,
3. Under conditions simulating war, including maneuvers or training,

or

4. By an instrumentality of war, such as weapons.

C. The member would be entitled to receive VA disability compensation for the same illness or injury that resulted in his or her entitlement had he or she made application.

241302. VA Compensation Awarded Prior to Separation. Finance offices will not withhold taxes if, before separation, the member provides documentation that he or she is entitled to disability compensation from the VA per subparagraph 241301.C., above.

241303. 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 also should 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. (reference (dy)) 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.

2414 TAXABILITY OF RETIRED PAY FOR FLEET RESERVIST/FLEET MARINE CORPS RESERVIST NOT PHYSICALLY QUALIFIED FOR RETENTION IN THE FLEET RESERVE/FLEET MARINE CORPS RESERVE (FR/FMCR)

The retired pay of a member of the FR/FMCR who is transferred to the retired list, when found not physically qualified for retention in the FR/FMCR (as stated in paragraph 020102 of this volume) is subject to FITW.