

**SUMMARY OF MAJOR CHANGES TO
DOD 7000.14-R, VOLUME 7B, CHAPTER 53
"SURVIVOR BENEFIT PLAN (SBP) - TAXABILITY OF ANNUITIES"**

Substantive revisions are denoted by a ★ preceding the section, paragraph, table or figure that includes the revision.

PARA	EXPLANATION OF CHANGE/REVISION	EFFECTIVE DATE
5301, Table 53-2, Bibliography	Interim change R01-01 incorporates the taxability of SBP cost refund.	January 17, 2001
Table 53-1	Interim change R09-02 excluded SBP annuities from federal taxation for Spanish nationals residing in Spain.	July 17, 2002
Table 53-1	Interim change R13-02 updates Table 53-1 to reflect no tax withholding for an annuitant who is a citizen and resident of the countries of New Zealand, Russia, and Kazakhstan. This change also adds no tax withholding for an annuitant who is a national and resident in the countries of China, Estonia, Hungary, India, Ireland, Latvia, Lithuania, Luxembourg, Mexico, Portugal, South Africa, Switzerland, Thailand, Turkey, and Venezuela.	October 24, 2002

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CHAPTER 53

SURVIVOR BENEFIT PLAN (SBP) – TAXABILITY OF ANNUITIES★5301 FEDERAL INCOME TAX

530101. Taxability of SBP Annuity Payments. The SBP annuity payments are taxable for federal income tax purposes. See table 53-1 for exceptions. See paragraph 530203 to determine SBP annuity payments are treated as “designated distributions” for tax withholding guidance purposes.

530102. Taxability of SBP Cost Refunds. A refund of SBP costs (i.e., SBP premiums, per subparagraph 530203.A) resulting from an administrative error, correction of records, or awarding of Dependency and Indemnity Compensation may or may not be taxable income to the member or the annuitant. The taxability of a SBP cost refund depends on the source from which it is made (also see Table 53-2):

A. It constitutes taxable gross income to the retired member or the annuitant when it is made from the premium deductions made from the retired member's taxable retired pay to pay for the cost of SBP coverage (defined in paragraph 420207).

B. It does not constitute taxable gross income to the retired member or the annuitant when it is made from the retired member's direct remittance payments (by check) to pay for the cost of SBP coverage.

C. It does not constitute taxable gross income to the retired member or the annuitant when it is made from the retired member's Department of Veterans Affairs (VA) disability compensation or by deduction from nontaxable military disability retired pay.

5302 FEDERAL INCOME TAX WITHHOLDING (FITW)

530201. Monthly or Periodic Payments. Monthly or periodic SBP annuity payments are treated as wages for federal income tax withholding (FITW) purposes. An annuitant, however, may elect no withholding of federal income tax. In the absence of an annuitant election, or if the annuitant does not otherwise submit a withholding certificate, the DFAS-Cleveland Center will withhold on the basis of “married, three exemptions.” The annuitant may use TD Form W-4P or any substitute form furnished by the payer.

530202. Notice Requirements. The DFAS-Denver Center must advise the annuitant of the withholding requirement, and the right to elect that no tax be withheld, when making the first monthly or periodic payment to the annuitant. Thereafter, the DFAS-Cleveland Center must provide annual notice to the annuitant of the right to elect no withholding, revoke an election or submit a new withholding certificate. An annuitant also may submit a withholding certificate at any time to elect no withholding, revoke an election, or request any rate of withholding.

530203. Lump-sum (One-time) or Nonperiodic Distribution Payments.

A. SBP Cost Refunds. An SBP cost refund is a refund of premiums, rather than a distribution of benefits. As a nonperiodic distribution, an SBP cost refund is subject to FITW at the rate of 10 percent. The annuitant, however, may elect no withholding of federal income tax. The annuitant has the right to make a FITW election for this refund separately from any election already in operation for all other SBP annuity payments.

B. Other. Lump-sum SBP annuity payments, other than the monthly or cost refund payments discussed above, are nonperiodic distributions to the annuitant and subject to mandatory FITW at the rate of 20 percent. An annuitant may not elect no withholding of federal income tax. **EXCEPTION:** If the lump sum payment of an SBP annuity is the result of administrative error or delay in the starting of an annuity, then the lump sum payment need not be treated as a payment subject to 20 percent FITW. Treat the payment as a periodic (or monthly) payment for tax withholding purposes (see paragraph 530201, above).

5303 INCOME EXCLUSION

530301. Consideration for Contract. The SBP annuitant is entitled to an income exclusion when, upon death of the participant member, the “consideration for contract” has been excluded in whole from the member’s gross income. After December 31, 1965, the member’s survivor who is receiving the annuity may exclude from gross income such annuity payments received until the total exclusion equals the portion of the “consideration of contract” not previously excluded from the member’s taxable income. The DFAS-Denver Center will accomplish the applicable direct reduction in taxable income for the annuitant and report the residual amount as taxable income on the annuitant’s Form 1099-R.

Example: When a member died on January 1, 1995, \$1000 of the total “consideration for contract” had not yet been excluded from the member’s nondisability retired pay. For 1995, the DFAS would have reported the taxable annuity less \$1000, and this reported residual amount would have been used by the surviving spouse in his or her income tax computation for the calendar year.

530302. Disabled Member’s Death Before Normal Retirement Age. In addition to the income exclusion allowed for “consideration for contract,” the survivor of a member who retired because of a physical disability resulting from military service and died after September 20, 1972, but before August 21, 1996, before reaching normal “retirement age,” may exclude an aggregate of \$5,000 from taxable income on income tax returns. The survivor includes amounts in excess of \$5,000 in gross income. The DFAS-Cleveland Center should, upon request, provide the effective date of premiums, the total premiums paid (showing separate totals for deductions and direct remittances), the effective date, and amount of annuity.

530303. Direct Cost Payments. The tax-free benefit on SBP premiums is not available to members who waived military retired pay to receive disability compensation from the VA (see paragraph 450602 of this volume). Instead, upon the member's death, the annuity paid to the member's survivor will be exempt from federal income tax until the amount excluded equals the total of the member's direct cost payments.

5304 ADJUSTMENT TO TAXABLE ANNUITY

Reserved.

5305 AMOUNT OF ANNUITY SUBJECT TO FEDERAL ESTATE TAX

The value of the annuity at the time of the member's death may be subject to federal estate tax if any portion of the cost was paid by direct remittance, or if the value of the annuity exceeds the amount that may be excluded from the gross estate. The DFAS may furnish the annuitant the current annuity amount and/or a summary of annual payments, and total cost paid (separate totals for deductions and direct remittances). For a computation of the amount of an annuity that will be subject to the tax, if any, the executor of the member's estate may write to:

Internal Revenue Service
Chief, General Actuarial Branch (OP:E:EP:A1)
Room 2550
1111 Constitution Avenue, NW
Washington, DC 20224

Telephone (202) 622-7789

5306 STATE TAXATION

The Form 1099-R information is furnished to the appropriate state tax authority regardless of whether SBP annuities are subject to state inheritance or income tax. The method of calculating such tax depends upon the laws of the state concerned.

5307 FURTHER TAX INFORMATION

Survivors should be advised that they may obtain further information concerning taxation of SBP annuities from the cognizant District Director of Internal Revenue or the cognizant state tax authority.

TAXABILITY OF SURVIVOR BENEFIT PLAN/RETIRED SERVICEMAN'S FAMILY PROTECTION PLAN-NONRESIDENT ANNUITANTS RESIDING OUTSIDE THE UNITED STATES				
R U L E	A	B	C	D
	If the SBP annuitant resides in the country of	and	then the SBP annuity is	at the rate of
1	Australia, Belgium, Cyprus, Egypt, Finland, France, Germany, Iceland, Kazakhstan, Korea, Morocco, Netherlands, New Zealand, Norway, Pakistan, Romania, Sweden, Russia, Trinidad and Tobago, and United Kingdom	is a citizen of the country in which residing	not taxable (see note).	
★2	China, Estonia, Hungary, India, Ireland, Italy, Latvia, Lithuania, Luxembourg, Mexico, Portugal, Spain, South Africa, Switzerland, Thailand, Turkey, and Venezuela	is a national of the country in which residing		
3		is not a national of the country in which residing	taxable	30 percent.

Note: In order to claim entitlement to exemption from taxation based upon a tax convention or Treaty, a nonresident alien annuitant is required to file Treasury Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding).

★Table 53-1. Taxability Of Survivor Benefit Plan/Retired Serviceman's Family Protection Plan—NonResident Annuitants Residing Outside the United States★

★TAXABILITY OF SBP COSTS REFUND			
R U L E	A	B	C
	If the source of refunded cost is for	then it is taxable to the	
		member	annuitant
1	premium deductions from taxable retired pay	yes (note 1)	yes (note 2)
2	premiums paid from VA Disability compensation or premiums deducted from nontaxable military disability retired pay	no (note 3)	no (note 4)
3	premiums paid directly by member	no (note 5)	no (note 6)

NOTES:

1. Internal Revenue Code section 122 caused amounts deducted from military retired pay to fund an SBP annuity to be excluded from income. Had the deducted amount been paid directly to the member instead, it would have been fully taxable. Consequently, refunded costs that were taken from military retired pay constitute gross income to the member.
2. Under Internal Revenue Code section 691, the refund is income in respect of a decedent. The tax status of the refund is the same to the annuitant as it would have been had it been refunded to the member. Since the refund of costs deducted from military retired pay would have been gross income to the member, it is also gross income to the annuitant.
3. The VA disability compensation is exempt from taxation. 38 U.S.C. § 5301. Under certain circumstances, military disability retired pay is also nontaxable. 26 U.S.C. § 104. If the deducted amount had been paid directly to the member instead, it would have been exempt from taxation. Consequently, refunded costs that were taken from VA disability compensation or nontaxable military disability retired pay are also exempt from taxation.
4. Under Internal Revenue Code section 691, the refund is income in respect of a decedent. The tax status of the refund is the same to the annuitant as it would have been had it been refunded to the member. Since the refund of costs deducted from VA disability compensation or from nontaxable military disability retired pay would have been excluded from the gross income of the member, it is excluded from the gross income of the annuitant.
5. Amounts paid directly by the member to fund the SBP annuity were subject to tax before they were paid by the member. Direct payments by the member do not result in any tax benefit to the member. Consequently, refunds of premiums that were directly paid by the member constitute a nontaxable return of capital and do not constitute gross income.
6. Since the refund would have been a return of capital in the hands of the decedent (and would not have been includible in the decedent's gross income), it is also a return of capital to the decedent's beneficiary (and is not includible in the gross income of the beneficiary of the decedent).

★Table 53-2 — Taxability of SBP Cost Refunds

Chapter 53—Survivor Benefit Plan — Taxability of Annuities

5301—Federal Income Tax		ASD Memo, December 8, 1990 26 U.S.C. 3405
★	530102	DoD/GC(Fiscal) opinion March 7, 2000
5302—Federal Income Tax Withholding (FITW)		26 U.S.C. 3402(o)(3)
	530201	26 U.S.C. 3405(a) (1), (2)
	530203.A	26 U.S.C. 3405(b) (1), (2)
	530203.B	26 U.S.C. 3405(c) DFAS-DE/GM Memo, July 23, 1998
5303—Income Exclusion		26 U.S.C. 101 26 CFR 1.122-1(d) Treasury Reg. 1-122-1(b)
	530302	Public Law 104-188, section 1402(a), August 20, 1996
★	Table 53-2	DoD/GC(Fiscal) opinion March 7, 2000