TAXES AND MILITARY PENSIONS: THE LONG AND SHORT OF IT

*by Mark E. Sullivan

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Direct Payments When Possible

In a military divorce case, the nonmilitary spouse will often be concerned about pension share payments and taxes. She will invariably want to receive pension division payments direct from the retired pay center. For the Army, Navy, Air Force and Marine Corps, this is DFAS (Defense Finance and Accounting Service) in Cleveland, Ohio. Pension garnishments for the Coast Guard and the commissioned corps of the Public Health Service and of the National Oceanic and Atmospheric Administration are handled by the Coast Guard Pay and Personnel Center in Topeka, Kansas.

In the usual case, attempts to get the hypothetical servicemember, Colonel John Doe, to write a monthly pension share check to his ex-wife once he has retired may be an exercise in futility. Suppose he retires in another state. What if his retirement residence is in Germany or Japan? If he retires elsewhere, or if he insists on moving around from place to place, it will be virtually impossible for the former spouse to collect her share each month.

Direct pension payments by garnishment benefit COL Doe as well as his ex-wife. He needs to know that, with a garnishment, the military does the appropriate withholding before sending out checks. The ex-wife’s share of his military pension is automatically excluded from his taxable income. He receives (as she does) a Form 1099-R each January showing what the taxable income is for the prior tax year. He doesn’t need to keep track of writing a check every month to send it to his former spouse.

When Direct Payments Are Not Possible

But sometimes it is not possible to obtain payments through the military retired pay center. Pension garnishment payments for property division cannot be made through the pay center when there is not a 10-year overlap of the marriage and the period of creditable service.¹ In addition, there will be another gap of up to 90 days at the start of the pension garnishment process, to account for review and processing of the military pension division order (MPDO).² What good guidance can be given to Colonel Doe and his former wife in these situations?

Good Guidance Needed

Don’t expect that guidance from most lawyers. Few of them know a lot about the tax consequences of periodic payments from the former employee to the alternate payee in regard to division of a deferred compensation program. One premier family law attorney, when asked why she’d told her client there were no taxes due as to the receipt of monthly pension share payments from a Navy retiree, replied to this author, “because the payments are part of property division, not alimony, and everyone knows that property division payments are not taxed under Section 1041 of the Internal Revenue Code.” It is, of course, true that property transfers between spouses

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² Id.
under 26 U.S.C. 1041 are not subject to capital gains taxes, but this has no relationship to the issue at hand, which is pension-share payments from a military retiree to a former spouse.

Don’t expect guidance from appellate decisions in domestic cases involving pension division either. When higher courts mention tax aspects of pension division payments, which is rarely, they usually get it wrong. Two state court decisions, from the highest court in each state, approved of the division of the pension payment received by the retiree less taxes for the proper distribution of marital retirement benefits upon divorce. The Utah Court of Appeals in 2012 ruled that the military pension should be divided after the deduction of federal and state taxes. In 1995 the Superior Court of New Jersey, Appellate Division, reviewed without criticism or comment a trial-level judgment for military pension division that allocated “the Husband’s retirement pension less only Federal, State, or local Income Taxes properly withheld required by law....” In a 2011 decision, the Kentucky Court of Appeals affirmed a trial-level order which required the retiree to “withhold from the retirement benefits otherwise payable to [the former spouse]... a sum sufficient to pay all taxes imposed on [the retiree]... for that portion of his retirement....” A rare exception is found in Brown v. Brown, a 2010 trial-level decision from Connecticut. At the end of the decision, the judge wrote that “the court is under the assumption that the plaintiff [the retiree] will be able to deduct the full amount of that payment from his 2010 income tax return and the defendant [the former spouse] will be required to pick up that full payment on her 2010 income tax return.”

How to Do It

The Brown decision illustrates the correct approach. When the pension is divided in a written instrument and the payments end no later than the death of the payee, the military retirement payments are includable in the gross income of the payee, and they are excludable from the payor’s income.

A Tax Court case in 2000 confirms this. In Baker v. Commissioner, the ex-husband was a military retiree. He was ordered in the divorce decree to pay his ex-wife 50% of his military retired pay each month as part of property division. He made payments to her and deducted these as alimony on his Form 1040; his ex-wife did not report the payments as income, claiming that “the payments she received ... were in furtherance of a division of property and should be excluded from her income” under IRC Section 1041. The Tax Court ruled against her, stating that:

1) IRC Section 61 defines gross income as all income from whatever source, including alimony;
2) Whether a payment is alimony is determined by reference to Section 71;
3) Section 71(a) states that any amount received as alimony is included as income;
4) Sec. 71(b)(1) defines alimony as payment under the following terms –
   a) Any cash payment
   b) Received by a spouse under a divorce or separation instrument

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8 Id. at *14.
c) Which doesn’t designate the payment as non-includable within gross income under Section 71 and non-deductible under Section 215

d) And the parties are not members of the same household when the payment is made, and

e) There is no liability to make any payment after death of the payee spouse;

Thus if a payment satisfies all these factors, it is alimony. Here the Tax Court found that the direct payments from the retiree to his ex-wife were alimony (as the tax rules define it), even though intended as property division, and they were includable in the ex-wife’s gross income.

The Baker case is not unique. Numerous other cases make the same point – the periodic pension-share payments made from retiree to former spouse are included in her income and excluded from his. 10

When the retired pay center does not make direct payments to the former spouse, Colonel John Doe will need to make the payments to his ex-wife directly. He will have tax withheld on the entire amount that he received. He can exclude from his income any amount he paid her pursuant to the decree or agreement. His ex-wife is liable for taxes on the share of the pension that she received, and she should include the payments in her gross income.

How is this done? The payor’s payment may be entered as a negative number on the face of Form 1040 at Line 21 as “Other income,” as a negative at Line 16a, “Pensions and annuities” or at Line 31a, “Alimony paid.”11 He should, of course, attach to the tax return an explanatory note, along with appropriate documents to back up his position.

What about income for recipient? John Doe’s ex-wife will complete her own Form 1040 and this would show the payments which she received from Colonel Doe, pursuant to a written instrument, which are the division of this defined benefit program. She would reflect the gross amount paid to her by John under “Pensions and annuities,” which is line 16a.

To cover these contingencies, consider a clause in the court order or settlement document that says:

Periodic payments made by Husband directly to the Wife which are not done by garnishment through the military retired pay center will be included in Wife’s income under Sections 61 and 71 of the Internal Revenue Code, and these payments are likewise excluded for Husband from his gross income.

At the end of this paragraph, the drafting attorney may choose to insert the citations shown herein as authority for this clause.

State Income Taxes

While military retired pay is always subject to federal income taxation, one should not make the same conclusion in regard to state taxation. The states of Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no individual income tax, while New Hampshire

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and Tennessee only tax income derived from interest and dividends. Of the remaining states, about 16 have special rules for exemptions regarding military pensions. North Carolina, for example, grants a full exemption for retired military personnel who have five years of service as of August 12, 1989, and otherwise there is a deduction of up to $4,000 (for joint tax filers the limit is $8,000). The chart at Appendix 1 showing the special exemption rules is taken from www.military.com.

**Attorney Fees**

On a related tax note, a former spouse receiving or trying to get a share of military retired pay should always be advised about the possible deduction of legal fees for work done on obtaining a portion of the military pension. After all, the pension payments are taxable income for the former spouse. And the legal work was done, and fees paid, toward the production of taxable income. The former spouse should be sure to ask her tax preparer as to whether this is a deductible expense and, if so, how much may legitimately be claimed as a deduction.

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12 Reg 1.162-2(b)(7): “Generally, attorney’s fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney’s fee and the part of the other costs paid [by the wife] in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.”
Appendix 1: States with Special Military Retirement Pay Exemptions

The following States have special provisions for military or public pensions:

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<thead>
<tr>
<th>Alabama</th>
<th>Hawaii</th>
<th>Illinois</th>
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<tbody>
<tr>
<td>Kansas</td>
<td>Kentucky***</td>
<td>Louisiana</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Michigan*</td>
<td>Mississippi</td>
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<tr>
<td>Missouri++</td>
<td>New Jersey</td>
<td>New York</td>
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<tr>
<td>North Carolina+</td>
<td>Ohio</td>
<td>Pennsylvania</td>
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<tr>
<td>Wisconsin</td>
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* = Exempts USPHS and NOAA retired pay as federal employment.
*** = Exempt depending on date of retirement - prior to 1998; after this date, some may be exempt.
+ NC allows full exemption for retirees with five years of service as of August 12, 1989; otherwise a deduction of up to $4,000 ($8,000 for joint filers) is allowed.
++ Missouri has a Public Pension Exclusion which covers a portion of pension income.