Section A. Purpose and Scope

1. This INSTRUCTION provides information on the taxation of retired pay payable to commissioned officers of the Public Health Service (PHS).

2. For information on computation of retired pay, refer to Subchapter CC23.8, INSTRUCTION 2.

3. For information on the disability payment exclusion which is available to all permanently and totally disabled taxpayers until age 65, refer to Internal Revenue Service instructions. This tax exemption may be claimed in addition to the disability tax exemption explained in this INSTRUCTION.

Section B. Authority

Retired pay received as a member of the uniformed services, including the PHS Commissioned Corps, is included in gross income and is taxable for Federal income tax purposes under authority of 10 U.S.C. 1403. Disability retired pay received as a member of the uniformed services is exempt from Federal income taxation as provided in this INSTRUCTION under authority of 26 U.S.C. 104(a)(4). State income taxation depends on the laws of the particular State.
Section C. Taxation of Retired Pay

1. **Nondisability.** All nondisability retired pay is subject to Federal income taxation.

2. **Disability.** An officer who is eligible for disability retired pay may, at his/her election, receive retired pay computed by 2 1/2 percent of total years of service or by the percentage of disability, not to exceed 75 percent of basic pay.

**EXAMPLES**

An officer with 20 years is entitled to (20 x 2 1/2 percent) 50 percent of his/her basic pay as retired pay. If the officer is rated as 90 percent disabled, he/she is entitled to 75 percent (the maximum percentage) as a multiplier and all of the retired pay **may** be tax-free as indicated below.

An officer with 20 years of service and 30 percent disability is retired because of disability. The retired pay entitlement (20 x 2 1/2 percent) is 50 percent of basic pay. Since the disability rating is less than 50 percent, only that portion (basic pay times the disability rating) of the retired pay **may** be tax-free as indicated below.

An officer with 12 or less years of service and 30 percent or more disability is retired because of disability. The retired pay entitlement is the disability rating times basic pay limited to 75 percent of basic pay. All of the retired pay **may** be tax-free as indicated below.

a. **Retired before September 25, 1975.** If an officer, on or before September 24, 1975, was entitled to receive disability retired pay, and the retired pay is computed by the percentage of disability, all of the retired pay is exempt from Federal taxation. If the officer retired for disability and the retired pay is computed on the basis of years of service, that portion of retired pay which is based on the percentage of disability as indicated in the examples illustrated above is not included in gross income for Federal income tax purposes.

b. **Member of uniformed service before September 25, 1975.** If an officer was a member of a uniformed service (active or inactive status) on or before September 24, 1975, or was under a binding written commitment on that date to become a member of a uniformed service, and is subsequently retired because of physical disability, the portion of retired pay which is based on the percentage of disability as indicated in the examples illustrated above is not included in gross income for Federal income tax purposes.
c. **All other disability retirees.** If an officer not covered under Sections C.2.a. and b, above, is retired because of physical disability, the portion of his/her retired pay which is based on the percentage of disability as indicated in the examples illustrated above is not included in gross income for Federal income tax purposes only if the portion of retired pay attributable to disability is received by reason of combat-related injury. The term "combat-related injury" means personal injury or sickness which is incurred as a direct result of armed conflict, or while engaged in extrahazardous service, or under conditions simulating war; or which is caused by an instrumentality of war. Although this is the only tax exemption for disability retirement pay, an officer may gain a tax exemption by applying for disability compensation from the Veterans Administration (VA). The disability compensation is tax exempt but, to receive the VA disability compensation, an officer must waive the same amount of retired pay that an officer receives as compensation (see Subchapter CC29.6, Personnel INSTRUCTION 1, for more information on this subject).

**Section D. Tax Withholding**

Public Law 98-525, enacted October 19, 1984, authorizes the Uniformed Services to enter into agreements with State taxing authorities to withhold State income tax from the retired pay of a retired officer if the officer so requests. However, before this provision can be implemented, the Uniformed Services must enter into agreements with each State. (For this purpose, the Department of Defense represents all Uniformed Services.) As States enter into agreements with the Uniformed Services, the Commissioned Personnel Operations Division, Office of Personnel Management, Office of Management, will notify retired officers of such agreements by a message on monthly earning statements. Since State laws vary, the retired officer should consult the State tax regulations of his/her State.