

Taxing the Division of Military Retirement Pensions

by Craig D. Bell and Arthur C. Bredemeyer

The vast numbers of military personnel in Virginia—on active duty, in the reserves and retired—significantly increase the chance that Virginia attorneys will encounter them, no matter the practice area. Virginia attorneys in domestic relations practice should know about special provisions related to the separation and divorce of military personnel and retirees—they may have complex family situations or have traveled extensively through numerous jurisdictions. Moreover, some federal statutes specifically apply to their separation and divorce and the treatment afforded military retirement pensions.

In *McCarty v. McCarty*,¹ the Supreme Court decided that federal statutes prevented state courts from treating military retirement pay as community property. Congress, under political pressure and in direct response to the *McCarty* decision, enacted the Uniform Services Former Spouses' Protection Act (USFSPA).² The USFSPA is still being debated in the legislatures and courts. The tax treatment of dividing the military retired pension is sometimes overlooked. Attorneys who are unaware of this issue may find their clients affected, especially if they are advising on jurisdictions outside Virginia and do not know how to properly draft the separation or divorce instruments.

Pre Tax Reform Act of 1984 Treatment

It has often been said that you need to know where you are coming from before you can fully understand where you are. This is key in understanding the tax treatment of retired military pensions incident to separation or divorce. The dividing line between past and present is the enactment of the Tax Reform Act of 1984 (TRA 1984).³

Prior to 1985, transfers of property, including retired military pensions, that were made in return for the transferee's interest in the marital property required courts to examine state laws of ownership to determine what federal tax treatment was appropriate. There were different tax treatments between states for similar transfers. The leading case on the tax effects of marital property divisions was the U. S. Supreme Court decision in *United States v. Davis*.⁴ This case establishes the principle that where one spouse transfers property to another in satisfaction of the transferee spouse's marital or support rights, the transferor spouse realizes a gain or loss on the transfer. The amount of gain or loss recognized by the transferor spouse is the difference between the adjusted basis in the property and its fair market value on the date of transfer. The rules established by *Davis* did not apply in the case of equal divisions of community property,⁵ and the IRS determined that the rules did not apply to the partition of jointly held property.⁶

Because of the varying tax consequences that resulted from the importance given state law, Congress believed a change was needed.⁷ Congress decided that it was inappropriate to tax transfers between spouses.⁸ The law of property transfers incident to a divorce created controversy and litigation.⁹ Congress was concerned for the IRS, noting that the government frequently got whipsawed. The transferor spouse often reported no gain on the transfer, while the transferee spouse, upon subsequent sale of the property, was entitled under the *Davis* rule to compute the gain or loss by referencing a basis equal to the fair market value of the property at the time it was received.¹⁰

TRA 1984 created a new Internal Revenue Code section 1041. It reversed much of the *Davis* decision related to property transfers. The new section provided that there is no gain or loss recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse during the marriage or to "a former spouse, but only if the transfer is incident to the divorce."¹¹ The transfer is treated as a gift. The transferor's adjusted basis carries over to the transferee and becomes the recipient's basis. This carry-over of the transferor's basis obtains (as contrasted with the result under the gift rules), even if the fair market value of the property at the time of the transfer is less than the transferor's adjusted basis.¹²

The Tax Reform Act of 1986¹³(TRA 1986) made a technical change to I.R.C. § 267, which disallows losses between related taxpayers. Section 1842(a) of TRA 1986 created section 267(g) of the Code, which requires coordination of sections 267 and 1041.¹⁴ Two other changes by TRA 1986 were made to section 1041. Both involved transfers of property in trust. First, if a spouse transfers an installment obligation to a trust established for the other spouse, the deferred gain on the installment obligation is accelerated and recognized.¹⁵ Second, when a spouse transfers property subject to liabilities that are in excess of basis to a trust that is established for a spouse, gain is recognized in the amount of the liabilities that exceed the basis.¹⁶ No gain is recognized where liabilities exceed the basis—if the property is transferred directly to the other spouse exclusive of the trust.¹⁷

Current Rules on Transfers between Spouses and Former Spouses

Currently, under section 1041, any transfer of property between spouses during the marriage or any property transfers after the marriage terminates, if such transfers are "incident to a divorce," are not taxable.¹⁸ All such transfers are treated as gifts,¹⁹ and the transferee's basis in the property shall be the adjusted basis of

the transferor.²⁰ Section 1041 applies to any transfer between spouses regardless of whether the transfer is a gift, a sale, or an exchange between spouses acting at arm's length.²¹ No divorce or legal separation need be contemplated between the spouses at the time of the transfer, nor does a divorce or legal separation ever have to occur.²² There is one exception to the tax-free transfer of property between spouses (or former spouses). If the transferee spouse (or former spouse) is a nonresident alien, then gain or loss is recognized at the time the property is transferred to the nonresident alien spouse (or former spouse).²³

A transfer of property is "incident to the divorce" if it occurs within one year after the date on which the marriage ends or is related to the cessation of the marriage.²⁴ If the transfer occurs not more than one year after the date on which the marriage ceases, the transfer does not need to be related to the cessation of the marriage to qualify for section 1041 treatment.²⁵ If the one-year "safe harbor" rule covering transfers made not more than one year after the marriage terminates is inapplicable, the transfer may still be tax-free if such transfer is related to the cessation of the marriage. A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument and the transfer occurs not more than six years after the date on which the marriage ceases.²⁶ A divorce or separation instrument includes a modification or amendment to such decree or instrument.²⁷

Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the cessation of the marriage is presumed to be unrelated to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouse at the time of the cessation of the marriage.²⁸ The IRS addressed the rebuttable presumption on two occasions. In both rulings the taxpayer successfully rebutted the presumption and received section 1041 treatment for the property transfers.²⁹ For purposes of Section 1041, annulments and cessations of marriage are void *ab initio*, due to violations of state law constitute divorces.³⁰

In addition to direct transfers between spouses or former spouses, certain "indirect" transfers to third parties are permitted under section 1041. There are three situations authorized by the temporary regulations in which a third party may receive property on behalf of a spouse or former spouse, and no gain or loss will result to the transferring spouse. They are:

- when the transfer to the third party is required by a divorce or separation instrument,
- when the transfer to the third party is pursuant to the written request of the other spouse (or former spouse), or,
- when the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party.³¹

In the last example, the consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of

section 1041. It must be received by the transferor prior to the date of filing the transferor's first tax return for the taxable year in which the transfer is made.³² In each of these three situations, the transfer of property is treated as if it were made by the nontransferring spouse (or former spouse) to the third party. This deemed transfer by the nontransferring spouse (or former spouse) is not a transaction that qualifies for nonrecognition of gain under section 1041.³³ Thus, the nontransferring spouse (or former spouse) may have to recognize gain or loss as a result of the transfer.

The breadth of the nonrecognition-of-gain rule of section 1041 means that it also overrides other normal gain recognition events. For example, the nonrecognition treatment afforded spouses overrides the gain normally recognized when property that is subject to liabilities that exceed the adjusted basis of the property is transferred between spouses or former spouses.³⁴

Retired Military Pensions

The division of retired military pensions or any other retirement benefits, which may frequently be the couple's most significant asset, requires an examination of both state and federal tax law. In the case of military retired pay, USFSPA is the federal law authorizing state courts to determine the nature of the property interests created. Once a determination is made, IRC 1041 may become applicable. The resulting treatment generally hinges upon whether or not the property is community property. The language used in the separation and divorce instruments may also impact the taxation treatment resulting from the division of the retired military pension. It can cause an otherwise IRC 1041 nontaxable division of property to be treated as alimony,³⁵ deductible by the payor and includable in the payee's income.

*Balding v. Commissioner*³⁶ is a post-1984 TRA case involving the division of military retired pensions in community property jurisdictions. It is often used as a starting point for analysis. This case concerned an IRS private letter³⁷ ruling that payments made by the husband to the wife in exchange for the wife's relinquishment of claims on her ex-husband's military retirement plan under the USFSPA should be treated as an assignment of the wife's future right to receive income—not as a tax-free transfer of property under section 1041(a)(2). The wife was required to report her receipt of the payments as ordinary income under I.R.C. § 61.

In Private Letter Ruling 8813023, Mrs. Balding's marriage was dissolved in a community property state (California) in December 1981. At that time, the Supreme Court's ruling in *McCarty* was in effect. Pursuant to the *McCarty* decision, the divorce decree stated that the husband's military retirement plan was the separate property of Mr. Balding. After passage of the USFSPA, Mrs. Balding moved to modify the divorce decree to recognize her interest in her husband's military retirement plan and then agreed to relinquish her claims in exchange for three payments by Mr. Balding: \$15,000 in 1986, \$14,000 in 1987, and \$13,000 in 1988.

The IRS ruled in Private Letter Ruling 8813023 that such payments would be taxable to Mrs. Balding upon her receipt of the income. The IRS said that the payments should be treated as an assignment of Mrs. Balding's future right to receive income, not

as a tax-free transfer of property under I.R.C. § 1041(a)(2). The IRS also said that Mrs. Balding would be required to report the three payments as ordinary income in the respective tax years.

Mrs. Balding filed a petition with the tax court, which ruled in her favor.³⁸ The tax court concluded that the cash payments to Mrs. Balding were “property” within the meaning of I.R.C. § 1041 and they were therefore excludable, notwithstanding the argument made by the IRS that the assignment of income doctrine required taxation of the three payments. In a footnote, the tax court expressly declined to rule whether the assignment of income doctrine might apply in future years when actual payments were made under the plan to Mr. Balding. It cited Professor Michael Asimow’s article, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 Tax L. Rev. 65 (1988), as authority for the argument that Mrs. Balding was not required, under the assignment of income doctrine, to take into income any portion of the retirement benefits.³⁹

Subsequent decisions in community property jurisdictions have decided that IRC § 1041 does not apply to the division of retired military pensions because there is no transfer of property. In one such decision, *Fulgham v. Commissioner*,⁴⁰ the petitioner and her former husband were divorced in Texas. Under the decree of divorce, the court awarded Mrs. Fulgham 20% of her husband’s net military retirement pay (gross pension, VA compensation and federal income tax withheld) as a property settlement. Mrs. Fulgham did not report any portion of the distribution and received a notice of deficiency dated August 18, 1999, for \$1,515. The petitioner disputed the deficiency determination and contended that the pension was taxable only to her husband. The petitioner also contended that if she were responsible for the tax, she should get 20% credit of federal income tax withheld in determining “net.” The tax court found that military retirement benefits earned during marriage are community property in Texas.⁴¹ They are characterized as compensation for services that are earned over the course of employment, and under Texas law, a spouse’s rights to her husband’s military retirement benefits become vested at the time such benefits are earned.⁴² The petitioner did not present any evidence that it was not community property. Since the petitioner had a vested interest in the retired military pension, she had to pay tax on that share of it when received.⁴³

In a more recent California case, *Weir v. Commissioner*,⁴⁴ the tax court reached the same decision as *Fulgham* and distinguished itself from *Balding*. The petitioner argued that at the time of the divorce, her husband was ordered to make settlement payments to her in lieu of her community property interest in the military retirement benefits. She argued that she received cash settlement payments while her ex-husband received the benefits as his separate property.⁴⁵ While this appears similar to the *Balding* fact situation, the tax court elected not to accept this argument and emphasized that the separation agreement and addendum to the separation agreement, which were both incorporated into both the interlocutory judgment of dissolution of marriage and the final judgment of dissolution of marriage, contained language that clearly identified her as having a “vested community interest” in the pension. The tax court wrote that the petitioner had

not convinced them that the agreement language intended anything other than his acting as a collection agent on her behalf.⁴⁶

There is a shortage of decisions dealing with IRC § 1041 property transfers in Virginia, compounded by the fact that Virginia is an equitable distribution law jurisdiction, not a community property jurisdiction. A recent case in Oregon⁴⁷ points to what one should expect in a similar Virginia situation. In *Huggins v. Commissioner*, the petitioner and her husband’s marriage was dissolved by a decree of dissolution of marriage effective January 18, 1986. The decree included a provision providing that the husband will pay to petitioner, “a sum of money equaling one-half of monthly net amount, after deductions for federal and state taxes, of the U.S. Coast Guard retirement pension received by [the petitioner’s former husband]. Payment to [the petitioner] shall not be included as taxable income to [the petitioner], nor shall such payments be deductible by [the petitioner’s husband].”⁴⁸ The decree further directed that the payments be made directly to the petitioner and continue until the mortgage on the marital home is paid or foreclosed upon, or sold.⁴⁹ The IRS argued that what the petitioner received was “. . . simply a right to receive a future stream of income.”⁵⁰ The tax court opined that under Oregon law the retired military pension was property and that the petitioner’s husband was the recipient of the pension. Thus, the petitioner’s husband remained fully taxable on his retired pay.

While Virginia and other equitable distribution law states are more than likely to find that retired military pensions are property of the retired military person, and the division and awarding of a portion to the former spouse is a nontaxable event under IRC § 1041, the attorney must be careful in drafting the separation or divorce instruments. The Internal Revenue Service will likely assert that the non-military spouse is receiving a taxable income stream of property payments. Currently pending before the Tax Court is *Pfister v. Commissioner*, a docketed case addressing this exact issue involving Virginia taxpayers. The evidence is in, and briefs have been filed.⁵¹ Furthermore, if not properly drafted, there is a chance the pension payments or cash equivalents may be treated as alimony instead of a property transfer. In *Baker v. Commissioner*,⁵² an Alabama case, the divorce decree indicated that the payments were a “property settlement.” Because the decree did not clearly designate that the payments were non-taxable under IRC § 71 or non-deductible under IRC § 215, such payments were alimony and should be included in petitioner’s income.⁵³

Conclusion

Whenever there is a separation or divorce, there will be important tax implications for both parties. In the case of military retirees, next to the family residence, the most significant asset is the military retiree’s pension. IRC § 1041 can be used, if state law deems the pension as property, to divide and award a portion of the military pension annuity to the former spouse as a nontaxable event. However, if in a community property jurisdiction or if the dissolution instruments are poorly drafted, the former spouse may end up being taxed as receipt of pension income or receipt of alimony. Furthermore, the Internal Revenue Service will likely assert the non-military spouse receiving a military pension payment

is receiving taxable income in equitable distribution law states. Whether this result is correct remains to be seen. A decision on the pending *Pfister* case is not expected until next year. 📌



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Endnotes

- 1 453 U.S. 210 (1981).
- 2 10 U.S.C. § 1408 (1982). Provided that States may treat military retirement benefits as community property and the effective date was made retroactive to the day before the Supreme Court decided *McCarty*.
- 3 Pub. L. No. 98-369, 98 Stat. 494 (1984).
- 4 370 U.S. 65 (1962)
- 5 H.R. Rep. No. 4170, 98th Cong., 2d Sess., 1491 (1984).
- 6 Rev. Rul. 74-347, 1974-2 C.B. 26.
- 7 H.R. Rep. No. 4170, 98th Cong., 2d Sess., 1491 (1984).
- 9 *Id.* The rules often proved a trap for the unwary as, for example, where the parties viewed property acquired during the marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggered recognition of gain.
- 10 *Id.* At 1491-92.
- 11 I.R.C. § 1041(a); Temp. Treas. Reg § 1.1041-1T, Q&A-1 (1984).
- 12 I.R.C. § 1041(b).
- 13 Pub. L. No. 99-514, 100 Stat. 2085 (1986).
- 14 I.R.C. § 267(g); *see also* Rev. Rul. 76-377, 1976-2 C.B. 89. Section 1041 expressly provides that both gains and losses will not be recognized in transfers between spouses. Section 267(g) insures that section 267(d), which does permit a loss created by a transfer between related taxpayers to offset a subsequent gain caused by the sale or other disposition of the asset, does not apply. For example, a husband sells 100 shares of stock for \$5,000 to his wife. The husband's basis in the stock was \$10,000. Under section 1041(b), the wife takes the husband's basis of \$10,000 and the husband does not recognize any loss by virtue of section 1041(a). If section 267(d) were permitted to apply, in addition to section 1041, a subsequent sale of the stock by the wife for \$14,000 would provide her with a gain of \$4,000 (\$14,000 sale proceeds—\$10,000 basis), and this gain could be reduced by section 267(d) by offsetting the gain with the previously disallowed loss of \$5,000 to the husband when he originally sold the stock to his wife. Section 267(g) precludes this offset. The full \$4,000 gain must be reported.
- 15 I.R.C. § 453B(g).
- 16 I.R.C. § 1041(e).
- 17 *Id.*
- 18 Priv. Ltr. Rul. 92-50-031 (Sept. 14, 1992).
- 19 I.R.C. § 1041(b)(1).
- 20 I.R.C. § 1041(b)(2).
- 21 Temp. Treas. Reg § 1.1041-1T(a), Q&A-2 (1984).
- 22 *Id.*
- 23 I.R.C. § 1041(d); Temp. Treas. Reg § 1.1041-1T(a), Q&A-3 (1984). The purpose of this exception is presumably because nonresident aliens frequently are not subject to United States tax by virtue of tax treaties or there is simply a failure to report a subsequent sale of the appreciated transferred property by the nonresident alien spouse (or former spouse). Such tax avoidance is possible since nonresident aliens generally are not subject to United States tax on property sales outside of the United States.
- 24 I.R.C. § 1041(c); Temp. Treas. Reg § 1.1041-1T(b), Q&A-6 (1984).
- 25 Temp. Treas. Reg § 1.1041-1T(b), Q&A-6 (1984).
- 26 Temp. Treas. Reg § 1.1041-1T(b), Q&A-7 (1984); *see also* Priv. Ltr. Rul. 88-33-018 (May 20, 1988); and *Young v. Commissioner*, 113 T.C. 152 (1999), *aff'd*, 240 F.3d 369 (4th Cir. 2001).
- 27 *Id.*
- 28 *Id.*
- 29 Priv. Ltr. Rul. 92-35-026 (May 29, 1992). The husband and wife entered into a property settlement that required the husband to purchase the wife's entire interest in a business and in certain realty held by the business for a specified sum. The husband refused to purchase the business and real property under the agreement. The husband disputed the price, and the parties agreed to arbitrate the matter. A tentative arbitration agreement was reached, but the husband again refused to purchase the business and realty. The wife then initiated a lawsuit to enforce the transfer as set forth in their marital separation agreement. The former spouses settled, and the husband purchased the business and real estate. The transfer of property occurred more than six years after the date of their divorce. The IRS ruled that the wife's transfer of the business and related realty to her former husband qualified for nonrecognition treatment as a transfer between former spouses incident to divorce under section 1041(a). *See also* Private Letter Ruling 91-23-053 (November 13, 1992). IRS ruled that a taxpayer's payment of one-half of a business interest (in a community property state) to his former spouse in monthly installments lasting more than six years after the divorce qualified as nontaxable transfers under section 1041. The IRS stated it was clear that the payments were being made to accomplish a division of property owned by the couple at the time of divorce.
- 30 Temp. Treas. Reg § 1.1041-1T(b), Q&A-8 (1984).
- 31 Temp. Treas. Reg § 1.1041-1T(b), Q&A-9 (1984).
- 32 *Id.*
- 33 *Id.*
- 34 Temp. Treas. Reg § 1.1041-1T(d), Q&A-12 (1984).
- 35 26 U.S.C. § 71.
- 36 98 T.C. 368 (1992).
- 37 Priv. Ltr. Rul. 88-13-023 (Dec. 29, 1987).
- 38 98 T.C. 368 (1992).
- 39 98 T.C. at 373 n.8.
- 40 T.C. Summary Opinion 2001-29 (March 14, 2001)
- 41 *Id.* at 5.
- 42 *Id.*
- 43 *Id.* at 6.

44 *Weir v. Commissioner*, 82 T.C.M. (CCH) 281 (2001).

45 *Id.* at 286.

46 *Id.* at 287

47 T.C. Summary Opinion 2001-69 (May 14, 2001).

48 *Id.* at 2.

49 *Id.* at 3.

50 *Id.*

51 *Pfister v. Commissioner*, Docket No. 1846-00, United States Tax Court.

52 *Baker v. Commissioner*, 79 T.C.M. (CCH) 2050 (2000).

53 *Id.* 2055.