February 2024
Legislative Revenue Office
160 State Capitol Building, Salem, Oregon 97301 | 503.986.1266

Tax Treatment of Military Pension Income and Examination of Policy Proposals

Introduction

This report was prepared at the request of the Oregon Senate Committee on Veterans, Emergency Management, Federal and World Affairs and dovetails with 2023 policy proposals relating to the taxation of military retirement income.[1] With Section 219 of SB 5506A (2023), the Legislature appropriated $220K to the Oregon Department of Veterans Affairs to study and make policy recommendations on the tax treatment of military pensions. In November of 2023, the appropriation to the Department of Veterans Affairs was rescinded and the Legislative Revenue Office (LRO) was requested to prepare a report for the 2024 legislative session providing information and revenue impact estimates of policy proposals modifying Oregon's tax treatment of military retirement income. This paper provides a general overview of the military retirement system and associated income tax implications.

This report begins with a brief discussion of how retirement and pension income is taxed by Oregon. The report then provides a description of the military retirement system, followed by descriptive information of military retirees, including information such as age, retirement income received, and income characteristics. The following section provides revenue impact estimates of four policy proposals discussed during the 2023 legislative session that proposed exempting all, or a portion of, military retirement income from Oregon's income tax. The report concludes with Section 5, which presents a table displaying the military retirement income tax policy of the 50 states and D.C.

Table of Contents

Taxation of Retirement and Pension Income 2
Military Retirement 2
Military Pensioners 5
Revenue Impacts of Policy Proposals 8
Other States 10
Bibliography 11

[1] See Senate Bills 178, 515, 540 from 2023.

Taxation of Retirement and Pension Income

Oregon's personal income tax is based on the federal personal income tax through Oregon's connection to the federal definition of taxable income. Gross income subject to taxation is broadly defined as income from whatever source derived and includes income from such sources as pensions and annuities, and tax deferred retirement accounts. A pension is generally described as a series of determinable payments made to individuals after they retire and is based on such factors as years of service and prior compensation. Examples of pensions include employer based defined benefit and defined contribution plans, and 401(k), 403(b) and 457(b) retirement savings plans. Individual retirement arrangements (IRAs) differ from pensions in that such accounts are a personal saving plan of an individual.

The tax treatment of the savings in, and distributions from, pensions and retirement savings accounts is nuanced and complex. Legal requirements exist regarding pension and retirement plan design and administration, and requirements regarding tax advantaged contributions and distributions from such plans. Generally, pension and retirement savings account distributions are fully taxable at time of distribution if the individual's contributions (if any) were not subject to taxation at time of contribution. If pension or retirement savings contributions were subject to taxation at time of contribution, then distributions from such accounts are generally not subject to taxation at time of distribution.[2] The primary tax benefit to individuals from tax advantage retirement savings accounts is the tax deferral on earnings which allows earnings to accumulate tax free until time of distribution.

In addition to the aforementioned general tax provisions relating to pension and retirement income, Oregon excludes from personal income taxation, otherwise taxable pension income attributable to federal employment before October 1, 1991.[3] For taxpayers receiving federal pension income attributable to employment both before and after 1991, the income exclusion (claimed as an income subtraction on the Oregon tax return) is prorated based on months of federal service before 1991. Oregon's federal pension income tax subtraction originated in 1998 as a result of a series of court cases relating to Oregon's tax treatment of Oregon Public Employees Retirement System (PERS) pensions. Ultimately, Oregon enacted a tax exclusion for federal pension income attributable to federal employment pre-October 1, 1991. This tax exclusion was enacted to correct a violation of federal law in which Oregon was treating Oregon pension income differently than federal pension income.[4]

Military Retirement

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. Most of the provisions also apply to retirement systems for members of the Coast Guard and officers of the National Oceanic and Atmospheric Administration. There are three general categories of military retiree pay, 1) active duty non-disability retired pay, 2) retired pay for reserve service, and 3) disability retired pay. The military retirement system and associated pension income is distinct from benefits administered by the Department of Veterans Affairs, which are exempt from income taxation.[5] Military retirement

---

[2] Roth IRAs provide an example. Contributions to Roth IRAs are made with "after-tax" income, meaning contributions are subject to the personal income tax prior to being deposited into the Roth IRA. Subsequent qualified distributions from the Roth IRA are not subject to income taxation because they were previously subject to income taxation.

[3] Federal pension is defined in ORS 316.680 as "any form of retirement allowance provided by the federal government, its agencies or its instrumentalities to retirees of the federal government or their beneficiaries".

[4] For a general background see https://www.oregonlegislature.gov/lro/Documents/taxation_pensions.pdf

[5] Benefits and pensions provided by the Department of Veterans Affairs are not subject to income taxation. There

income is generally subject to income taxation, though exceptions do exist. The table below displays how military retirement income is treated for income tax purposes in Oregon.

Table 1. Tax Implications of Military Retirement Income

Military Retirement Category	**Income Subject to OR Taxation?** (Income earned post Oct. 1, 1991)	**Implications for Potential OR Income Tax Exclusion**
Active Duty Non-Disability	Taxable • Defined benefit (DB) pension • Blended Retirement System (BRS) defined contribution (DC) retirement distributions contributed pre-tax, and employer contributions Non-taxable • BRS DC retirement distributions from after-tax (Roth) contribution account	• Twenty years of service required to earn DB pension, average service length is about 23 years and average age at retirement is about 44 • Age of individual receiving pension can vary and younger individuals often earn income from other sources • Timing of retirement income for more recently retired (BRS) can vary from non-BRS due to DB and DC portions of retirement & potential lump sum payments paid upon initial retirement
Reserve Retirement	Taxable / non-taxable aligned with active duty non-disability above	• Generally, become eligible to receive retirement pay at age 60
Disability	Service-connected disability may be exempt if combat related or if other qualification criteria are met (see disability retirement section)	• Income may be exempt under existing law

Active Duty Non-Disability Retired Pay

The military retirement system and associated pension benefits have been modified at various times in the previous forty years and four distinct benefit formulas are in operation today. The current retirement system includes both a defined benefit (DB) and defined contribution (DC) element.[6] The DB pension amount is determined by formula, though formula factors can vary based on when an individual entered military service and discretionary benefit decisions of an individual.

$$DB\ pension\ amount = pay\ amount * \ factor\ \% * \ years\ of\ service$$

Non-disabled members must have at minimum twenty years of qualified service to receive a DB pension amount. This twenty year minimum requirement results in relatively younger individuals receiving military

are two main veterans' pension programs, and both have specific qualification requirements that include income limitations.

[6] Defined benefit (often known as a traditional pension plan) plans provide a fixed, pre-established benefit for employees at retirement and are often based on employee earnings and years of employment with the employer. Defined contribution plans (e.g., 401(k)) are designed to allow an employee and/or employer to contribute to the employee's individual retirement account with such accounts often qualifying for tax advantages.

pension income. For non-disability active duty military personnel retiring in fiscal year 2022, the average age at time of retirement was 44.4 years and the average number of years of service was 23.0 (DOD, 2023).

Military personnel who joined uniform service on or after January 1, 2018, are mandatorily entered into the Military's Blended Retirement System (BRS) which consists of both a DB and DC retirement element. Personnel that joined on or after January 1, 2006, and before January 1, 2018 may elect to participate in BRS. All other personnel do not participate in BRS and receive a DB annuity based pension amount though variation in DB formula and an optional cash payment did exist depending on when the individual joined uniform service.

An important distinction from a tax perspective of the BRS is the inclusion of a defined contribution (DC) retirement element known as the Thrift Savings Plan (TSP). BRS participating individuals have a portion of their monthly pay automatically contributed to their TSP account with a government contribution equal to 1% of pay and a government matching contribution up to an additional 4%.[7] Contributions to the TSP can be traditional pre-tax contributions where income tax is levied at time of distribution, or after-tax Roth contributions where income tax is levied when contribution is made (with subsequent retirement distributions being tax free). Taxes and an early withdrawal penalty may apply to TSP withdrawals taken prior to age $59^1/_2$.

The pension formula for military retirees not participating in BRS is generally based on final rate of monthly pay or average pay for highest 36 months, multiplied by 2.5%, multiplied by years of service. The pension formula for BRS participating retirees is similar, using average monthly pay for the highest 36 months, 2.0% and years of service. BRS regular retirees may also opt to receive a lump sum payment at time of retirement in-lieu of a portion (either 25% or 50%) of their defined benefit (DB) amount. Electing the lump sum payment reduces the monthly retirement payments to the retiree for period of initial retirement until retiree reaches full Social Security retirement age, at which point monthly pension payments return to 100% formula value.[8]

Reserve Retirement

The retirement system for reserve military members is similar to active duty non-disability retirement pay. The reserve retirement DB pension income amount is determined using the same formula (pay amount × % factor × years of service). The date the reservist became a member determines the percentage factor used in formula and whether member participates in BRS. Two key distinctions exist for reserve retirement compared to active duty non-disabled. First, while reserve service members must also complete 20 years of service, qualifying for a year of service is based on an earned point system where reserve members earn points based on their reserve activities in a calendar year. Second, reservists must reach retired pay eligibility age which is generally 60 years of age.[9]

Disability Retirement

Servicemembers who are unable to perform their military duties due to a medical condition may qualify for military disability retirement. To qualify, the disability must be of a permanent stable nature

---

[7] Service members are automatically enrolled in the TSP at a 3% contribution of pay rate. Enrollment is optional, though service members must opt-out annually to avoid being reenrolled at a 3% contribution rate.

[8] Retiree can elect to reduce monthly pension payments by 50% or 25%, with size of lump sum payment reflecting discounted value of the monthly payment reduction. For example, electing a 50% reduction in monthly payments results in a larger lump sum payment but reduces monthly pension payments by 50%.

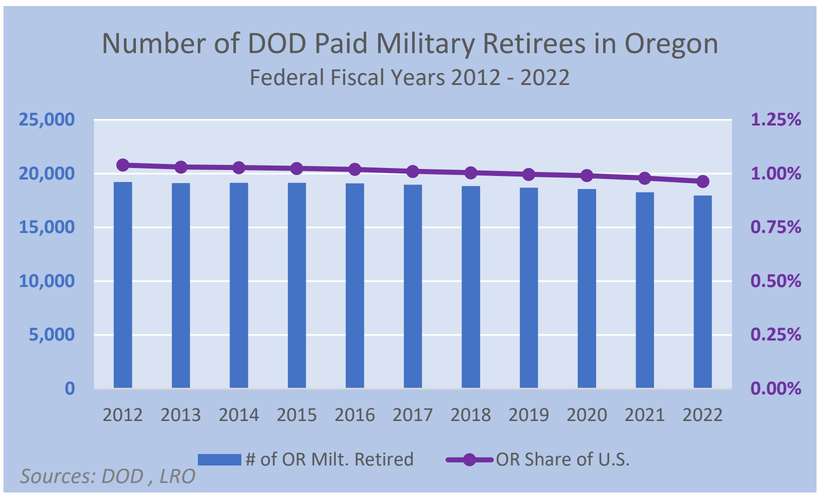
[9] Initial retired pay eligibility age can range from 50 to 60 depending on how many days of certain types of duty the reservist performed during their career.

incurred while the individual was entitled to basic pay, was not due to intentional misconduct or willful neglect, and the disability has a rating of at least 30% under the standard schedule of rating disabilities in use at the time by the Department of Veterans Affairs. In disability retirement, the servicemember may select one of two options for determining monthly retired pay: 1) accrued non-disability retirement benefit regardless of eligibility to retire, or 2) base pay multiplied by the rated percent of disability. Service-connected disability pension income is not subject to taxation if any of the following conditions apply.

1) Disability is the result of a combat-related injury
2) Member was entitled to receive a disability payment before Sept. 25, 1975
3) Member was in the Armed Services prior to Sept. 25, 1975, and later became eligible for disability retired pay.

Military Pensioners

The U.S. Department of Defense (DOD) annually publishes the Statistical Report on the Military Retirement System which contains summary level information of military retirees, including the number of retirees and amount of retirement income paid by DOD. The report provides information at the national and state level, and categories by type of service and military branch.[10] DOD annual reports were one of two primary sources of information used in preparing this report. A second significant source of information is Department of Revenue (DOR) tax return data for residents reporting military retirement income. This section provides a description of military pensioners based on both data sources, while the next sections provide revenue impact estimates for four possible changes to tax policy.



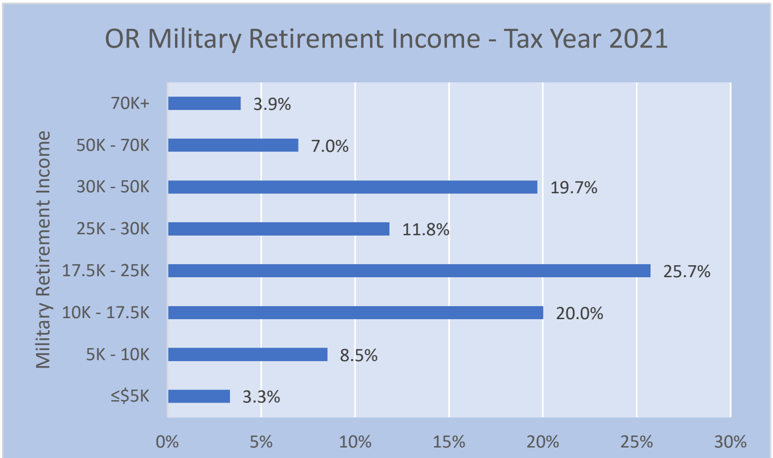
As of Sept. 30, 2022, about 1.87 million military retirees in total were paid by DOD and received on average, about $2,700 in retirement pay for the month of September (about $32,500 annualized). The chart to the right displays the number of military retirees in Oregon paid by DOD for federal fiscal years (FYs) 2012 through 2022. The number of DOD paid retirees in Oregon has been relatively constant over the preceding ten years at about 18K-19K though the number has trended down slightly in recent years. As displayed by the purple line in the chart, Oregon military retirees as a percentage share of the overall U.S. total has trended downward slightly, from 1.04% in 2012 to 0.96% in 2022. For federal FY 2022, DOD paid just under 18,000 military retirees about $510M in total retirement

DOD Paid Military Retirees in Oregon - Fed. FY 2023		
Retirees	Amt. Paid (Annualized)	Annual Avg.
17,981	$509.8M	$28,353

[10] DOD's annual report consistently publishes information for the Army, Navy, Marines and Air Force (reserves included). Oregon proposals to exclude military retirement income from Oregon personal income tax have generally applied to "Armed Forces of the United States" which would also include the Coast Guard (Space Force being included in the Air Force category).

pay, or an annual average of $28,350 per retiree.[11] In prior years, published figures indicate Oregon Coast Guard retirees account for an additional 6% of retirees, or nearly 1,100 paid retirees.

As described in the Military Retirement section of this report, retirement pay is determined by formula and reflects pay received and years of service. As such, military retirement pay can vary considerably. For example, in federal FY 2022, officers received on average about $60,000 annually as compared to the overall military retiree average of $32,500, or $20,000 for reserve retired (DOD, 2023).[12]

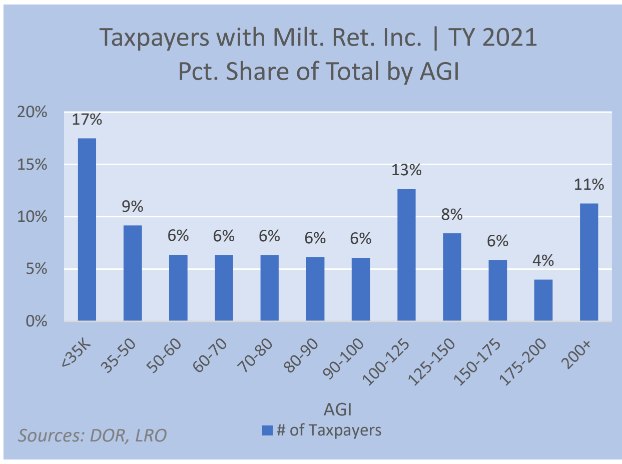


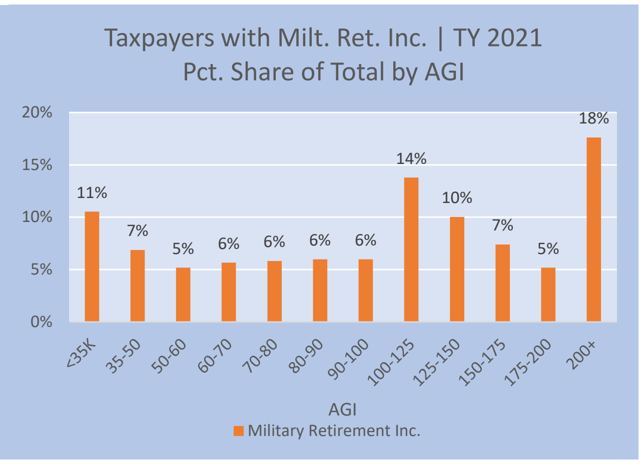
Sources: DOR, LRO

Relying on tax return data, the chart to the right displays the shares of military retirement income received by Oregon full year resident taxpayers by income level. The data are for tax year 2021. The income categories are narrower at the lower end based on 2023 legislative policy options to exclude from taxation a taxpayer's initial $17,500 in military retirement income.[13] Nearly one-third of taxpayers reported receiving less than $17,500 in military retirement income for TY 2021. Taxpayers reporting military retirement income of $25K or less represent 58% of all taxpayers receiving such income.

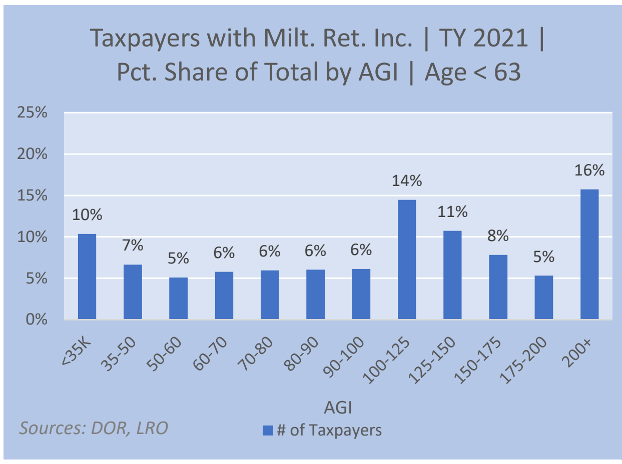
Other proposals discussed during the 2023 session crafted the tax benefit in terms of the age of the taxpayer receiving military retirement income or their adjusted gross income (AGI). The exhibit to the lower left (blue columns) displays the share of the number of taxpayers reporting military retirement income by the AGI. As displayed, 17% of these taxpayers had an AGI of less than $35,000 contrasted with 11% of such taxpayers having an AGI exceeding $200,000. The exhibit to the lower right (orange columns) displays the share of total reported military retirement income by AGI level. Using the same bookends as examples, 11% of military retirement income is reported by taxpayers with an AGI below $35,000 whereas 18% of such income is reported by taxpayers with an AGI exceeding $200,000.[14]

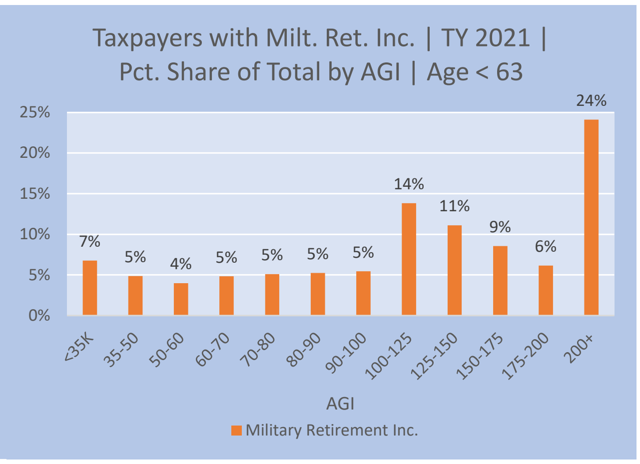
[11] Figures are annualized based on number of DOD paid retirees and amount of payments made in Sept. 2022.
[12] Figures exclude disabled retirees.
[13] See SB 540 -4 from 2023 legislative session.
[14] This reflects that taxpayers receiving a greater amount of military retirement income will generally have higher AGIs reflective of the retirement income's contribution to a taxpayer's total income.





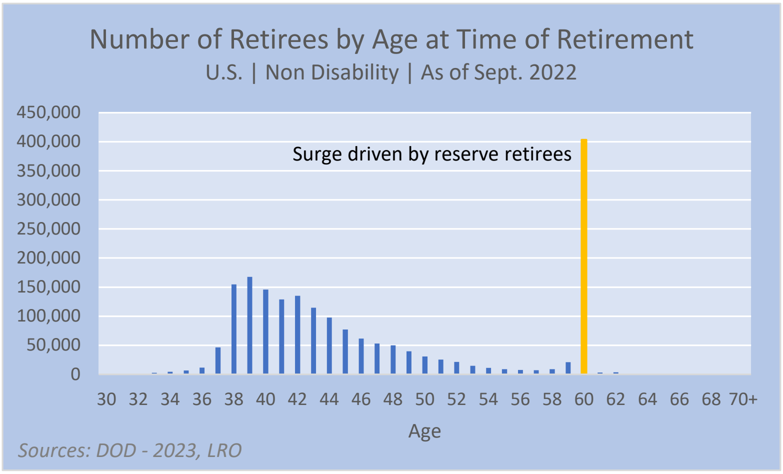
The next two column charts (below) display the same information but only for taxpayers under the age of 63. Multiple factors contribute to the differences in the distributions bifurcated by age. Younger taxpayers are more likely to have greater sources of other earned income, contributing to a higher AGI on average. Reserve military members generally begin receiving retirement income at 60 or later and tend to have lower average retirement pay.





As discussed in the military retirement section, retirement becomes an option after twenty years of service, so military retirees often begin receiving retirement income at a relatively early age (mid 40's). This often leads to military retirees engaging in a second career following military service (Loughran, 2002). While reserve retirees can become initially eligible for retirement pay as early as age 50, most become initially qualified at age 60.

The chart to the right displays the number of current U.S. retirees (nondisabled), as of Sept. 2022, and the initial age at which retirement began. The initial age when retirements begin in sizeable number is age 37/38 with peak retirement age at 39. A large number of retirements occur at age sixty reflective of reserve retirees becoming retirement eligible.



The chart to the lower right displays the number of current U.S. retirees (nondisabled), as of Sept. 2022, by the current age of the retiree.

SB 540 -4 (2023) proposed a partial income tax exclusion of military retirement income for a taxpayer that has not attained 63 years of age before the close of the taxable year. Retirees under the age of 63 represent about 40% of all non-disabled retirees.

Revenue Impacts of Policy Proposals

As described in Table 1, both active duty non-disability and reserve retirement income are sources of military retirement income that are generally subject to Oregon income tax whereas disability retirement income may be exempt from taxation depending on qualifying factors. Veterans' benefits are excluded from taxation.

The proposals presented in this report are based on policy discussions that occurred during the 2023 legislative session. Generally, the proposals allow qualified taxpayers receiving military retirement income to claim an Oregon income tax subtraction equal to a specified amount of military retirement income.[15] Revenue impact estimates for the four proposals presented in this report are contained in the table below; estimates are provided for the current and following two biennia. All four policies are assumed to take effect beginning with the 2024 tax year, resulting in a reduction in tax revenue beginning midway through the 2023-25 biennium.

The revenue impact estimates were made through an analysis of tax returns reporting military retirement income in Oregon and military retirement information published by the U.S. Department of

[15] An Oregon income tax subtraction effectively excludes such income from Oregon income taxation.

Defense. The estimates include the assumption of a relatively constant number of military retirees in Oregon in future years. Growth in revenue loss results from a combination of inflation adjustments to military pension income, inflation adjustment to the $17,500 subtraction limit beginning in 2025, and from the expected decline in Oregon's pre-1991 federal pension income subtraction (causing a greater amount of military pension income to be subtracted under proposed policies as compared to existing general federal pension subtraction). Projected growth of military pension income was also informed by published DOD actuarial assumptions.[16] These multiple factors influencing growth cause varying revenue impact growth rates across the four policies.

Table 2. – Revenue Impact Estimates

Revenue Impact Estimates - Military Retirement Income Exemption | $ Millions					
	Fiscal Year		Biennium		
Policy	2023-24	2024-25	2023-25	2025-27	2027-29
1. Exempt all Military Retirement Pay		-$30.7	-$30.7	-$69.2	-$79.7
2. Exempt up to $17.5K if Age < 63		-$8.4	-$8.4	-$18.0	-$19.4
3. Exempt up to $17.5K		-$15.6	-$15.6	-$33.8	-$37.3
4. Exempt all Milt. Ret. Pay if Age < 63		-$17.3	-$17.3	-$37.0	-$39.9

Note: For policies 2 & 3, $17.5K exemption amount is indexed to inflation beginning tax year 2025.

Policy 1. Exempt all Military Retirement Pay[17]

This policy would exempt all military retirement income from the Oregon income tax.[18] Roughly 19,000 Oregon taxpayers would be affected with an average tax reduction of about $1,600 in 2024.

Policy 2. Exempt up to $17,500 in Military Retirement Pay for Taxpayers < 63 Years Old[19]

The policy would allow taxpayers under the age of 63 to subtract from Oregon taxation up to $17,500 of military pension income, leading to an average tax reduction of about $1,200. Approximately 7,000 Oregon taxpayers would be affected. Roughly 1/3rd of these taxpayers have an adjusted gross income (AGI) of less than $80,000, about 1/3rd have between AGI $80,000 and $150,000 and about 1/3rd have an AGI exceeding $150,000.

Policy 3. Exempt up to $17,500 in Military Retirement Pay

This policy would allow all qualifying taxpayers to subtract from Oregon taxation up to $17,500 of military pension income, an average tax reduction of about $800. About 19,000 Oregon resident taxpayers would be affected.

Policy 4. Exempt all Military Retirement Pay for Taxpayers < 63 Years Old

This policy would exempt all military retirement income received by taxpayers less than 63 years of age, an average tax reduction of about $2,450. Approximately 7,000 Oregon taxpayers under the age of 63 would be affected. About 1/3rd of these taxpayers have an AGI of less than $80,000, about 1/3rd between $80,000 and $150,000 and about 1/3rd with an AGI exceeding $150,000.

---

[16] See (DOD, 2024)

[17] Closely aligns with SB 515 (2023)

[18] Exemption assumed to apply to "Armed Forces of the United States" as defined in SB 540 (2023) which includes members of Army, Navy, Air Force, Marine Corps, Coast Guard and Space Force.

[19] Aligns with SB 540 -4 (2023)

Other States

The table below displays the tax treatment of military retirement income for the 50 states and District of Columbia.

Table 3. – Tax Treatment of Military Retirement Income by State

Tax Treatment[20]	States		
States (with an income tax) that do not tax military retirement income (26)	Alabama Arizona Arkansas Connecticut Hawaii Illinois Indiana Iowa Kansas	Louisiana Maine Massachusetts Michigan Minnesota Mississippi Missouri Nebraska New Hampshire	New Jersey New York North Carolina North Dakota Ohio Oklahoma Pennsylvania Wisconsin
States partially taxing military retirement income (11)	Colorado Delaware Georgia Idaho	Kentucky Maryland New Mexico **Oregon**	South Carolina Virginia West Virginia
States fully taxing military retirement income (6)	California Montana	Rhode Island Utah	Vermont Washington D.C.

Sources: (Intuit, 2024), (U.S. Army, 2024)

[20] Eight states do not impose an income tax (Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming).

Bibliography

CRS. (2022). *Military Retirement: Background and Recent Developments.* Congressional Research Service.

DOD. (2023). *Statistical Report on the Military Retirement System FY 2022.* U.S. Department of Defense Office of the Actuary.

DOD. (2024). *Valuation of the Military Retirement Fund FY 2022.* U.S. Department of Defense Office of the Actuary.

Intuit. (2024, January 24). *States that Don't Tax Military Retirement*. Retrieved from Intuit turbotax: https://turbotax.intuit.com/tax-tips/military/states-that-dont-tax-military-retirement/L6oKaePdA

JCT. (2021). *Present Law and Background Relating to Retirement Plans.* Joint Committee on Taxation.

Loughran, D. (2002). *Wage Growth in the Civilian Careers of Military Retirees.*

U.S. Army. (2024, January 24). *State/Territory Benefits*. Retrieved from MyArmyBenefits: https://myarmybenefits.us.army.mil/Benefit-Library/State/Territory-Benefits