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CONTROLLING AND MINIMIZING THE TAXATION OF DISABILITY BENEFITS

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I. INTRODUCTION

A taxpayer receiving disability benefits often relies on the payer of the benefits to determine the extent they are taxable, particularly when the benefits arise out of an employment relationship. Although the payer is usually experienced at applying the tax rules, the recipient of the benefits nevertheless has a much greater stake in an accurate determination. Consequently, the recipient is often well advised to ask his or her tax advisor to review the payer's determinations and seek a revision when appropriate. For example, a tax advisor's review may disclose that the payer computed the taxable percentage of disability benefits based on inappropriately determined classes of employees or improperly selected plan data.

Other situations may also call for the help of a tax adviser. For example, a tax advisor should be able to explain the different tax consequences of disability benefits and retirement benefits when a taxpayer has a choice between the two. The advisor may help (1) find the most tax-advantageous way to allocate damages in the settlement of a disability dispute or (2) structure the settlement to eliminate tax on the income element in periodic payments. The advisor may help a taxpayer convert military retired pay to nontaxable military disability benefits or nontaxable veteran's benefits. The advisor may document the validity, for tax purposes, of a retroactive redetermination of nontaxable workers' compensation.

In other contexts, a tax advisor may help an employer structure a disability plan that is most advantageous to both the employer and employees. For example, an employer may be able to provide employees with a choice between disability plans with different tax and economic consequences – with little or no tax consequence to the employer. This Article will discuss these and other tax planning considerations.

The law governing taxation of disability benefits is extensive. Generally, though, disability benefits fall into two categories for tax purposes: (1) those benefits taxable or nontaxable depending on their source of funding and (2) those nontaxable regardless of their source of funding. The latter nontaxable category includes disability payments (a) under workers' compensation acts, (b) for disfigurement or loss of limbs or bodily function, (c), for injuries caused by terrorists or the military, (d) for combat-related injuries, and (e) under judgments or settlements for wrongful injury or sickness.

This Article will refer to the latter nontaxable category of benefits as "exempt disability benefits" and will use the term "sourced disability benefits" to refer to disability benefits that are taxable or nontaxable depending on their funding source. For this purpose, "disability benefits" mean a payment or payments dependent on short-term or long-term physical or mental disability – most usually intended to replace some or all of the lost wages, salary, or other compensation of the disabled individual. The term does not include any payment that reimburses medical expenses, as defined in section 213(d), or any payment under a long-term care insurance contract, as defined in section 7702B(b). Nor, for purposes of this Article, does it include social security disability benefits (which, as discussed below, are generally taxable in the same way as regular social security retirement benefits).[2]

II. DISABILITY BENEFITS TAXABLE OR NONTAXABLE DEPENDING ON SOURCE OF FUNDING

Benefits (other than exempt disability benefits) will be sourced disability benefits if paid for personal injury or sickness under an insurance contract, or under some other arrangement of similar effect.[3] An arrangement is of similar effect if it has the characteristics of insurance and is not merely a reimbursement arrangement.[4] Thus, an arrangement having the effect of insurance must provide for shifting and distributing of risk.[5] For example, the Service has ruled that a funded uninsured plan of a partnership had the characteristics of insurance because it shifted the risk of economic loss from individual partners and employees and redistributed the risk among the partners and employees.[6]

In addition, benefits may qualify as sourced disability benefits even though not paid as insurance – if they are paid under (1) a plan for employees or (2) a sickness and disability fund for employees maintained by a State or the District of Columbia.[7] A plan for employees may be either formal or informal and need not be in writing.[8] However, if the employee's rights are unenforceable, the employee must have had notice of the plan when he or she became sick or injured.[9] If the plan evidences an intent to provide disability benefits, it does not matter that the plan also provides other types of benefits – for example, retirement benefits.[10]

Most generally, the sources of funding for sourced disability benefits will consist of one or more of (1) the taxpayer, (2) the taxpayer's employer, or (3) other employees of the employer.

A. Disability Benefits Nontaxable Due to Employee Contributions

A taxpayer's sourced disability benefits are not includable in gross income to any extent if they are entirely attributable to contributions by the taxpayer and other employees.[11] Those contributions include the following:

1. Direct payments of disability insurance premiums by the taxpayer or other employees.[12]

2. Employer payment of disability insurance premiums includable in the gross income of employees.[13]

3. Direct contributions by the taxpayer or other employees to an uninsured disability fund maintained for employees.[14]

4. Employer contributions to an uninsured disability fund if the contributions are includable in the gross incomes of employees.[15]

Thus, for example, a taxpayer's disability benefits are not includable in gross income to any extent if paid under an individual insurance policy for which the taxpayer directly paid all the premiums.[16] Similarly, disability benefits are totally excludable if an employer paid the entire amount of the premiums from after-tax amounts withheld from employee gross income. Further, disability benefits are not taxable if an employer adds the entire amount of its premium payments to the gross income of employees.[17]

Finally, disability benefits are entirely excludable if paid under a plan receiving only employee contributions (and not employer contributions).[18] In fact, disability benefits are excludable if they are entirely attributable to contributions of any persons other than an employer, provided the benefits are paid as insurance or under a plan for employees. For example, disability benefits were not taxable when received by an injured passenger under the driver's insurance policy.[19]

B. Disability Benefits Taxable Due to Employer Contributions

Sourced disability payments are includable in an employee's gross income to the extent the payments are attributable to employer contributions. Thus, sourced disability payments are includable in their entirety if the employer made all the contributions under a disability plan for employees.[20] For this purpose, employer contributions generally include employer payments of disability insurance premiums and employer contributions to an uninsured disability fund – provided the premiums or contributions were not included in the gross incomes of employees.[21]

Thus, sourced disability payments received from an insurer are entirety includable in gross income if the taxpayer's employer paid all the policy premiums without including any portion of the premiums in the gross income of any employee. Similarly, sourced disability payments are entirety includable if made by an uninsured funded plan that received only employer contributions not included in employee gross income.[22] Further, benefits received from a state sickness and disability fund for employees are entirety includable if the taxpayer's employer made all the contributions to the fund without including any portion of the contributions in employee gross income.[23]

C. Partially Taxable Benefits Due to Partial Employer Funding

If a disability plan for employees receives contributions from both employer and employees, generally only a portion of each sourced disability payment is includable in gross income. The includable portion is the amount attributable to the employer's contributions.[24] However, the method for determining the includable portion is different depending on whether the plan involves an individual disability insurance policy, a group disability insurance policy, or uninsured coverage.[25]

1. *Individual Disability Insurance Policy*

If an employee receives a sourced disability payment under an individual insurance policy, the determination of the portion includable in gross income is relatively straightforward – at least for a payment received in the same policy year the disability originated. The includable portion is equal to the amount of the disability payment multiplied by a fraction. The numerator of the fraction is the employer's contribution toward payment of the premium for the policy year. The denominator is the total contributions of both the taxpayer and employer toward the premium.[26]

Example 1. Assume an employee receives payments under an individual insurance policy during the period March through September 2006 for a disability that occurred in March 2006. Assume the employer contributed $150, and the employee contributed $300, toward premiums for the policy year ended November 30, 2006. Then, one-third ($150 divided by $450) of the disability payments are taxable for 2006.

However, for a multi-year continuing disability, it is not so clear how an employee should compute the includable portion for policy years after the initial year of disability. That is, it is unclear whether an employee should compute the includable portion based on premium contributions for (a) the policy year of receipt of a disability payment or (b) the policy year in which the disability originated. The regulations provide that the includable portion is the amount "which bears the same ratio to the *amount received* as the portion of the premiums paid by the employer for the *current policy year*" bears to total premiums paid for that year (emphasis added). The proximity of the phrases "amount received" and "current policy year" does imply that the relevant "current" year is the policy year in which the taxpayer receives the payment, rather than the initial year of disability.[27]

On the other hand, a taxpayer might argue he or she should be able to compute the includable portion of disability payments based on premium contributions for the policy year the disability originated. The Code and the regulations require the inclusion in gross income of the portions of disability payments that are "attributable" to employer contributions. In this connection, disability payments appear to be most directly attributable to insurance risk coverage existing when the underlying disability first occurs.[28] The existence of such coverage, in turn, appears to be most directly attributable to contributions made to pay premiums for the policy year in which the disability originated. After that initial year, the already disabled employee is no longer receiving insurance coverage against the risk of disability.[29]

Computing the portion of disability payments includable in gross income based on contributions made for the policy year of receipt, rather than the policy year of initial disability, could lead to consequences the Service surely did not intend. For example, such a rule would allow an employer and employee to decrease the includable portion of payments received after the initial year of disability simply by changing the relative contributions of the employer and employee for those years. In addition, the includable portion would become impossible to compute for those years if, as usual, the policy waived all payments of premiums during the period of disability. That is, the ratio of employer contributions to total contributions becomes meaningless if both contribution amounts are zero.

2. *Group Disability Insurance Policy*

The portion of a sourced disability payment includable in gross income under a group insurance policy also equals the amount of the payment multiplied by a fraction. However, the numerator of the fraction is the total contributions of the employer during three policy years ending before the calendar year of receipt of the disability payment. Those three policy years must also be the most recent years for which contribution amounts are known as of the beginning of the calendar year of receipt – at least when the disability originated in that calendar year. The denominator is the total amount contributed toward the premiums by the employer and all employees during the same three-year period.[30]

Example 2. Assume an employee becomes disabled in 2006 and receives disability payments that year under a group insurance policy with a policy year ending April 30. Assume that, as of January 1, 2006, the employer knows employer contributions total $30,000 for the three policy years ended April 30, 2003, 2004, and 2005. Assume total employer and employee contributions for the same three-year period are $40,000. Then, three-fourths ($30,000 divided by $40,000) of the disability payments received in 2006 are taxable.

If, however, contributions were known for only one or two prior policy years, the taxpayer or employer would use those years instead. If contribution amounts are not known for any policy year (for example because the policy is new), the taxpayer or employer must (1) estimate the employer and employee contributions for the first policy year or (2) use contributions for a policy year that became known during the calendar year.[31]

3. *Multi-Year Disability Covered by Group Insurance*

The computation method described above for group policies is clear enough for disability payments received during the initial year of an employee's disability. However, for subsequent years, it is unclear whether an employee should compute the includable portion based on premium contributions for the most recent policy years before (1) the calendar year in which the disability originated or (2) the calendar year of receipt of a disability payment.

The regulations simply provide that the includable portion is the amount "which bears the same ratio to the *amount received* as the . . . net premiums contributed by the employer for the last three policy years . . . known at the beginning of the *calendar yea*r" bear to total premiums for such three policy years (emphasis added). The proximity of the phrases "amount received" and "calendar year" does imply that the relevant calendar year is the year of receipt of a disability payment, rather than the initial year of disability.[32] Under this interpretation, the includable portion of payments may vary over future years of a continuing disability as the relative premium contributions of employer and employees vary during those future years – as illustrated by the following example.

Example 3. Assume that in Example 2 above the employee's disability continues into the following year 2007. Assume that, as of January 1, 2007, the employer knows employer contributions total $40,000 for the three policy years ended April 30, 2004, 2005, and 2006. Assume total employer and employee contributions for the same three-year period are $50,000. Then, four-fifths ($40,000 divided by $50,000) of the disability payments received in 2007 are includable in gross income (even though in Example 3 only three-fourths of payments were includable in the prior year 2006).

But such an interpretation of the regulations does not seem particularly apt. Insurance coverage protects against the occurrence of uncertain future events (*i.e.*, possible disability). However, after the initial year of an employee's continuing disability, the employee no longer receives insurance coverage of that kind, but rather receives the benefits of prior insurance coverage. In fact, most policies recognize the effective suspension of insurance by waiving payment of premiums while the employee is disabled. It seems irrelevant that the employer and other employees meanwhile continue payment of premiums for coverage of other able-bodied employees.

In this connection, the regulations do refer repeatedly to the disabled employee's insurance coverage – more particularly to the contributions and premiums paid "for such coverage." The implication is that the focus is on the prior employer and employee contributions that provided insurance coverage for the disabled employee and provided his or her eventual disability benefits, rather than on contributions after the employee's disability that merely provide future insurance coverage for other employees.[33] In the words of the Code, the includable portions of disability payments seem to be more directly "attributable to" contributions by the employer made before the disability than contributions by the employer made after the disability.[34]

It thus seems more reasonable for the taxpayer or employer to make the computation for future years using the contribution history of the plan, but by excluding policy years ending during or after the calendar year of the employee's initial disability. That has the effect of taking into account only contributions used to provide insurance coverage for the disabled employee prior to the occurrence of the insured event.[35] In most cases, it would freeze the includable fraction of future disability payments and thus avoid frequent redeterminations during the period of disability.[36] The following example illustrates this possible interpretation of the regulations.

Example 4. Assume that in Example 2 above the employee's initial disability in 2006 continues into the following year 2007. Assume that, as in Example 2, employer contributions total $30,000 for the three policy years ended before the calendar year of initial disability (*i.e.*, policy years ended April 30, 2003, 2004, and 2005) and total contributions are $40,000 for the same period. Then, as in Example 2, three-fourths ($30,000 divided by $40,000) of the disability payments are includable in gross income for 2007, and for all subsequent years of continuing disability.

Unfortunately, though, we do not know which interpretation of the regulations the Service or the courts will ultimately find acceptable.[37]

4. *Uninsured Disability Plans*

The portion of a sourced disability payment includable in gross income under a funded uninsured plan equals the amount of the payment multiplied by a fraction. The numerator of the fraction is the total employer contributions to the plan during the three calendar years immediately preceding the calendar year of receipt of the payment. The denominator is the total amount contributed by the employer and all employees during the same three-year period.[38]

Example 5. Assume an employee receives disability payments in 2006 under a funded uninsured plan. Assume total employer contributions to the plan are $25,000 for the 2003, 2004, and 2005 calendar years. Assume total contributions for the same three-year period are $50,000. Then, one-half ($25,000 divided by $50,000) of the disability payments received in 2006 are includable in gross income.

If a plan has existed for only one or two previous calendar years, the taxpayer or employer must use those years instead. If the plan has existed for less than a year, the taxpayer or employer must use (1) the elapsed portion of the current year, (2) the previous month, or (3) the quarter ending before the disability payment.[39]

This method of computation for a funded uninsured plan applies whether benefits are short-term or long-term. Specifically, the regulations governing funded uninsured plans explicitly require use of a taxable fraction derived from relative employer and employee contributions in years immediately preceding "the year of receipt" of each disability payment.[40] Thus, the taxable portions of long-term payments to an employee will generally vary in future years of disability as the relative contributions of employer and employees vary over those future years. This seems appropriate since, unlike an insured plan, an uninsured plan makes continuing future disability payments from a fund that includes recent (post-disability) contributions of the employer and employees. The following example illustrates the computation for future years of a continuing disability.

Example 6. Assume that in Example 5 above the employee's disability continues into the following year 2007. Assume employer contributions total $40,000 for the three calendar years ended April 30, 2004, 2005, and 2006. Assume total contributions for the same three-year period are $60,000. Then, two-thirds ($40,000 divided by $60,000) of the disability payments received in 2007 are includable in gross income (even though only one-half of payments were includable in the prior year 2006).

5. *More than One Class of Employees Covered by a Plan*

If employer or employee contributions to a plan differ for different classes of employees, the employer must (if possible) make the above-described computations separately for each class.[41] For this purpose, transfers of employees from one class to another will generally be effective for tax purposes if the transfers are not retroactive or otherwise manipulative.[42] Note that in defining separate classes, only comparative employer and employee contributions are relevant; all other factors are irrelevant. Thus, employees paying a higher proportion of the total contributions for their benefits will have a substantial stake in separation of the classes.[43]

6. *Plan Provides Disability Benefits and Other Benefits*

Determining the amounts of employer and employee contributions toward disability benefits may be difficult for a plan that provides both disability benefits and other types of benefits. Furthermore, the way the taxpayer or employer must allocate contributions within such a multi-benefit plan is different depending on whether the plan provides retirement benefits funded by a trust or annuity.[44]

a. Contributions Made to Retirement Plan Trusts or Annuities. If disability benefits are included in a retirement plan funded by a trust or annuity, the terms of the plan normally govern the allocation of contributions and plan earning. The plan governs the allocation if it specifies the portion of a taxpayer's contributions (and earnings thereon) allocable to the cost of disability benefits.[45]

If the plan terms do not allocate contributions between types of benefits, none of a taxpayer's contributions is generally allocable to the cost of the disability benefits. All the disability benefits are generally attributable to employer contributions and thus are taxable.[46] Nevertheless, a taxpayer's contributions are allocable to the cost of disability benefits if the plan has already paid out all employer contributions (and earnings thereon). If the plan provides separate accounts, a taxpayer need only track employer contributions to the taxpayer's own account for this purpose.[47]

b. *Contributions Made to Other Types of Multi-Benefit Plans.* Disability benefits may be part of a plan that provides two or more different types of benefits, none of which is a retirement benefit (*e.g.*, disability benefits and life insurance benefits). If so, the taxpayer or employer must attempt to determine the respective amounts of employer and employee contributions actually used to fund the disability benefits. If that is not possible, the taxpayer or employer must determine the portions of the disability payments attributable to employer and employee contributions based on the ratio of total employee and employer contributions to the plan.[48]

D. Corrections of Employer Errors or Methodology

If a taxpayer or his or her tax advisor finds that the taxpayer's employer did not use a proper method to determine the taxable portion of disability payments, the taxpayer may of course request that the employer revise its determinations. Unfortunately, though, if the employer refuses, the taxpayer appears to have little recourse against the employer in the federal courts. Instead, the taxpayer generally must pursue the matter with the Service, in the Tax Court, or in a suit for refund against the United States.

In *Mich. State Employees Ass'n v. Marlan*, [49], a federal district court held taxpayers could not obtain declaratory or injunctive relief requiring the Michigan State benefits director to redetermine the taxable portion of employee disability benefits (using three proposed employment classes instead of one). Although the State's immunity from suit did not protect the director, the court held that the Code allows recourse only against the United States for refund or determination of federal taxes. Although it might be possible as an alternative to use the state court system to force the employer to revise its method, the taxpayer would still likely have to convince the Service or a federal court that the revision is correct for federal tax purposes.

E. Plans Offering Employees an After-Tax Contribution Option

Some plans allow an employee to elect to bear the cost of disability coverage on an after-tax basis. For example, a group insurance plan may provide that an employee may elect to include his or her share of the group premium in gross income – while non-electing employees continue to exclude their share. The Service will generally recognize the election as effective if the employee made the election irrevocably before the beginning of the plan year.

In Rev. Rul. 2004-55,[50] the Service reasoned that such a plan provided for two different classes of employees, one class making taxable contributions of their entire share of the group premiums, and another class benefiting from nontaxable employer contributions of their entire share. Thus, allocations based on prior relative employer and employee contributions were not applicable since neither class, viewed separately, involved a combination of employer and employee contributions.[51] Consequently, an employee who suffered a disability in a plan year covered by his or her after-tax election could exclude the entire amount of disability benefits from gross income. On the other hand, a disabled employee who did not make the election had to include any disability payments in gross income.

There does not appear to be any express authority allowing a funded uninsured plan to offer a similar election. However, the rationale for allowing the election for an insured plan appears also to provide support for an election for an uninsured plan. That is, the different tax treatment of contributions creates two classes of employees, one class benefiting only from employer contributions and thus receiving includable benefits, and the other class benefiting only from employee contributions and receiving excludable benefits. It may be necessary, though, to establish separate funds for the two classes to avoid questions about commingling of employer and employee contributions.[52]

In addition, a funded uninsured plan that is elective may create other problems. For example, since contributions to such a plan necessarily depend on plan experience, the contribution amounts included in the gross incomes of electing employees may vary significantly and unpredictably from year to year.

A taxpayer will generally find it advantageous to make an available after-tax election if the amount of the disability benefit remains unchanged after the election. That is, the tax an employee pays on the contributions is generally small in relation to the tax otherwise payable on disability benefits.[53] However, the decision becomes more difficult if the plan provides smaller disability payments when payments are nontaxable.

F. Disability Benefits Paid to Former Employees

As noted above, sourced disability payments attributable to pre-tax employer contributions are taxable only if "received by an employee."[54] The natural question, then, is whether a laid-off, terminated, retired, or deceased employee continues to be an employee for this purpose. The Service has said yes, even if the surviving spouse or dependents of the employee actually receive the disability benefits.[55] The rationale of the rulings is that the benefits are "based solely upon the employment relationship."[56]

G. Potential Conversion of Benefits to Retirement Benefits

If a taxpayer is receiving sourced disability payments when he or she reaches minimum retirement age, the Service apparently believes the payments then become taxable as retirement benefits. For this purpose, minimum retirement age is the age the taxpayer is first eligible for retirement benefits if not disabled.[57] The Service's rationale for its position is presumably that, after minimum retirement age, a disabled person is no less retired than a non-disabled person who is retired. Consequently, the benefits are really retirement benefits to the extent paid in lieu of normal retirement benefits.

Thus, if a taxpayer receiving sourced disability payments of $3,000 per month becomes eligible for retirement benefits of equal amount at age 62, the Service apparently believes the disability payments then become taxable as retirement benefits. Of course, the method for computing the portion of benefits includable in gross income differs for retirement benefits and disability benefits. Thus, conversion of disability benefits to retirement benefits will generally be detrimental if a larger portion of the taxpayer's retirement payments is includable in gross income. On the other hand, the conversion may be advantageous if a smaller portion of the retirement benefits is includable.

Nevertheless, the Service's position should not affect the tax treatment of sourced disability benefits to the extent they exceed the retirement benefits the taxpayer would otherwise have been eligible to receive. Nor should the Service's position affect disability benefits not otherwise paid in lieu of retirement benefits – for example, if the taxpayer would not have qualified for retirement benefits if able-bodied.[58] Furthermore, by analogy to the rule applicable to workers' compensation, a taxpayer with the right to choose either sourced disability benefits or regular retirement benefits may be able to argue successfully that his or her choice should be respected for tax purposes.[59]

H. Disability Payments to Self-Employed Individuals

Disability benefits paid to a self-employed individual under an insurance policy are not taxable to any extent regardless of the source of funds used to pay premiums.[60] The insurance benefits are not taxable even though the self-employed individual was formerly a regular employee of the enterprise (for example, before becoming a partner). [61] However, uninsured disability benefits paid by a qualified retirement plan are taxable as plan distributions.[62] Other disability benefits paid to a self-employed individual directly from his or her enterprise, or from an uninsured nonqualified plan, should be taxable by default as ordinary distributions by the enterprise to its owner. These rules apply if the taxpayer was a self-employed individual at the time he or she became entitled to receive the benefits (*i.e.*, generally at the time of disability).[63]

I. Payroll Taxes and Withholding from Disability Payments

Income tax withholding from sourced disability payments may differ depending on whether the payments are received (A) from a qualified retirement plan[64] or an eligible state or local government plan[65] or (B) from some other type of plan.

1. *Disability Payments Under Certain Retirement Plans*

An employer plan generally must withhold income tax on the taxable portions of *periodic* disability payments at rates applicable to wages if the plan is a qualified retirement plan or an eligible state or local government plan.[66] These plans must also generally withhold income tax on the taxable portions of *nonperiodic* payments at a ten percent rate.[67] However, the taxpayer may eliminate withholding altogether by giving the plan clear written instructions not to withhold.[68] The election remains in effect until revoked.[69]

2. *Disability Payments Under Other Types of Plans*

An employer plan generally must withhold income tax on the taxable portions of disability payments at rates applicable to wages if the plan is neither a qualified retirement plan nor an eligible state or local government plan.[70] Nevertheless, income tax withholding does not apply to disability payments to a self-employed individual under such plans.[71] Nor does an insurance company need to withhold tax on payments under a disability policy unless the taxpayer so requests in writing.[72]

3. *Social Security Tax Withholding on Disability Payments*

The Federal Insurance Contributions Act (FICA) requires employers to withhold social security tax from disability benefits paid during the initial months of disability. However, withholding of the tax is not required after six full calendar months of disability.[73]

III. DISABILITY BENEFITS NONTAXABLE REGARDLESS OF SOURCE OF FUNDING

As previously noted, disability benefits that are nontaxable regardless of source of funding are generally those benefits attributable to the following:

1. Injuries or sickness covered by workers' compensation acts or similar statutes.[74]

2. Loss of limbs, loss of bodily function, or disfigurement.[75]

3. Injuries due to actions of terrorists or the military.[76]

4. Certain duty-related injuries or sickness of (a) military personnel and (b) a few other categories of government employees.[77]

5. Damages from lawsuits or settlements for physical injuries or sickness caused by tortious acts.[78]

A. Workers' Compensation Benefits

Workers' compensation acts provide employees with compensation for injuries or sickness occurring in the course of employment – regardless whether employees or employers are at fault. The acts also relieve employers of liability for the injuries or sickness.[79] The various states have of course enacted workers' compensation acts of general applicability. The federal government has also enacted workers' compensation acts such as, for example, the Federal Employees' Compensation Act,[80] and the Longshoremen's and Harbor Workers' Compensation Act.[81]

Workers' compensation benefits are generally excludable from gross income.[82] The benefits are generally excludable even if the taxpayer is able to work in some other occupation, or if the benefits are received by survivors of the taxpayer.[83] However, the exclusion does not apply to benefits in excess of amounts allowed by the applicable workers' compensation act. [84] Nor does the exclusion apply to benefits received by a retired taxpayer that depend on age, length of service, or prior employee contributions.[85]

1. *In the Nature of Workers' Compensation*

Compensation for employee injury or sickness may also be excludable from gross income if paid under a statute "in the nature of" a workers' compensation act[86] – even though the statute does not relieve the employer from potential liability.[87] To qualify as a statute in the nature of a workers' compensation act, the statute must specifically limit payments to compensation for injuries or sickness incurred in the course of employment.[88]

An ordinance or regulation of a state or local government may qualify as a statute for this purpose. However, contractual arrangements generally do not qualify.[89] For example, a union contract does not qualify unless the affected governmental body incorporates the contract into a statute.[90] Furthermore, the mere reduction of workers' compensation benefits by the amount of payments under a union contract does not convert the payments into workers' compensation benefits.[91]

a. *Meaning of Certain Workers' Compensation Terms.* The taxation of payments received under a statute in the nature of a workers' compensation act is easier to understand if certain terminology is first adopted. Thus, this Article refers to a disability statute in the nature of a workers' compensation act as an "occupational disability statute." A "non-occupational disability statute" means one that provides disability benefits only for injuries or sickness (1) not incurred in the course of employment or (2) whether or not incurred in the course of employment. A "dual-purpose statute" is a statute containing two clauses: a non-occupational disability clause and a separate occupational disability clause. Finally, this Article refers to *non-disability* benefits available at retirement age as "regular retirement benefits."

(Note that payments under a non-occupational disability statute generally constitute "sourced disability benefits," which are includable in gross income to the extent attributable to employer contributions, as discussed earlier in this Article.)

b. *Disability in the Course of Employment.* As noted, an occupational disability statute must specifically limit payments to compensation for injuries or sickness incurred in the course of employment.[92] That is, the statute must contain some identifiable provision or clause limiting payments to compensation for occupational injuries or sickness. It does not matter that the clause is contained in a dual-purpose statute.[93] Nor does it matter that occupational disability benefits are in the same amount as non-occupational disability benefits or regular retirement benefits.[94]

Thus, the distinction between a qualifying and a nonqualifying statute is often a matter of form. To illustrate, in *Byrne v. Commissioner*,[95] the Tax Court held that the taxpayer (a judge) could exclude disability benefits from gross income as payments in the nature of workers' compensation. The statute authorizing the payments provided that a disabled judge was not eligible for the payments "[1] unless credited with at least two years of judicial service or [2] unless the disability [was] a result of injury or disease arising out of and in the course of judicial service." The court found that the first clause was a non-occupational disability clause because its coverage included non-occupational injury or sickness and the second clause was an occupational disability clause because it covered only occupational injury or sickness.

Since the statute was a dual-purpose statute on its face, the court was not troubled by the obvious overlap of the two provisions. For example, the taxpayer in the case had incurred an occupational disability after two years of service, thus potentially qualifying under either statutory clause (*i.e.*, under either the occupational or non-occupational disability clause). The court was also not troubled that the statutory scheme provided occupational disability benefits in the same amount as potential non-occupational disability benefits or regular retirement benefits. The court did express some concern whether the State actually made the payments under the occupational disability clause, rather than the non-occupational disability clause. However, the court declined to address that issue since the Service did not raise it.

c. *Effect of Presumptions.* A statute may be an occupational disability statute even though it incorporates a rebuttable presumption that a specific type of injury or sickness occurred in the course of employment.[96] An *irrebuttable* presumption is more problematical.[97]

In *Take v. Commissioner*, [98] the Ninth Circuit held that a statute was not an occupational disability statute since it provided an irrebuttable presumption that heart, lung, or respiratory illnesses of firefighters and police officers were occupational illnesses. Because of the significant incidence of such illnesses in the general population, the court found that the presumption would necessarily allow recovery of benefits for non-occupational illnesses. For example, an employee could qualify under the presumption even though the employee was never significantly exposed to a disease-causing work environment. The court distinguished situations in which an irrebuttable presumption might be much more closely correlated with working conditions (for example, black lung disease contracted by coal miners).

d. *Effect of Poor Administration.* According to the Tenth Circuit, an occupational disability statute will not fail merely because a governmental unit administers it so poorly that some employees receive undeserved or inflated disability awards. In *Stanley v. United States*,[99] city firefighters and police officers received payments under occupational disability statutes. A high proportion of them had received their disability awards at normal retirement – many years after actually incurring their occupational injury or sickness. Furthermore, the belated awards merely recharacterized retirement benefits as disability benefits, without affecting the total amount of the benefits. Although many of the awards were suspect for these reasons, the court held that the statutes nevertheless qualified as occupational disability statutes.

The appellate court concluded that it was the job of the lower court to examine each employee's individual situation to identify any nonqualifying disability awards. Although the appellate court did not elaborate, substantial authority does support a court's authority to evaluate such awards independently for federal tax purposes.[100] For example, in *Robinson v.*

Commissioner, [101] the Tax Court held that it could disregard an allocation of damages in a settlement agreement approved and adopted by a state court. The Tax Court noted that the parties did not make the allocation at arm's length, the allocation affected only one party (and thus was non-adversarial and uncontested), and the allocation was tax-motivated.

A federal court should owe even less deference to a state agency or quasi-judicial entity awarding disability benefits, particularly if (as in *Stanley*) the only apparent effect of an award is the favorable recharacterization of payments for federal income tax purposes.[102] The issue does become somewhat more problematical if a disability award actually affects the total amount an employee will receive.[103] In any event, though, the dearth of cases addressing this issue may indicate the Service is reluctant to embark on employee-by-employee examinations of disability awards.

e. *Payments Made Under the Qualifying Statute.* After establishing the existence of a qualifying occupational disability statute, a taxpayer may still have to prove that his or her employer actually made the taxpayer's payments under that statute – and not under some other statutory or contractual arrangement. For example, the Tax Court held that a taxpayer suffering an occupational disability nevertheless could not exclude his disability payments from gross income under the occupational disability clause of a dual-purpose statute, since that clause did not cover the taxpayer's job category.[104] On the other hand, the Tax Court held that a taxpayer received excludable payments under an occupational disability statute rather than under a union agreement because the statute (1) pre-dated the union agreement and (2) provided vested rights not waived by the agreement.[105]

2. *Age, Length of Service, or Employee Contributions*

As previously noted, benefits received by a retired employee (or his or her survivors) are not excludable from gross income as workers' compensation to the extent the amount of the benefits depends on age, length of service, or employee contributions.[106] Thus, if benefits based on age, service, or contributions exceed benefits not so based, the excess may constitute "sourced disability benefits" (which are includable in gross income to the extent attributable to employer contributions, as discussed earlier in this Article).

Example 1. Assume a retired taxpayer is entitled to a monthly workers' compensation payment that is automatically the greater of two separately computed amounts. Assume the first computed amount is equal to 50 percent of the taxpayer's final monthly salary of $4,000 – or $2,000 per month. Assume the second computed amount is $3,000 per month based on age, years of service, and employee contributions. The taxpayer will thus automatically receive the larger amount of $3,000 per month. Nevertheless, the taxpayer may exclude the first computed amount of $2,000 per month as workers' compensation since the taxpayer is entitled to that amount in any event without regard to age, service, or contributions.[107]

Surprisingly, however, the Service has indicated in one ruling that it might ignore age and service factors not used directly in the computation of a retiree's disability payments. In the ruling, age and service were included among many factors entering into a very subjective determination of the employee's disability payments. The Service explained that age and service were "only considered as factors in determining the percentage of disability, not in directly calculating the annuity."[108] This statement deserves a degree of skepticism. It seems highly likely the Service would challenge any subjective determination of a retiree's "percentage of disability" that put substantial reliance on age and service.

Perhaps less surprising, benefits received before formal retirement may be excludable as workers' compensation even though they are based on age, length of service, or employee contributions. The regulations specifically provide that the disqualification for age, service, or contributions is applicable to a "retirement pension or annuity."[109] A federal district court seized on this language to hold that the regulatory disqualification does not apply to wage continuation payments (*i.e.*, sick pay) received before formal retirement.[110]

3. *Choice of Disability or Retirement Provisions*

If a taxpayer's disability occurs after he or she reaches retirement age, the taxpayer may be able to choose between (1) workers' compensation benefits and (2) regular retirement benefits. If the taxpayer chooses workers' compensation benefits, the benefits are excludable from gross income (to the extent not based on age, service, or contributions).[111] If the taxpayer chooses regular retirement benefits, the benefits are includable in gross income (to the extent they exceed return of investment).[112]

Example 2. Assume a taxpayer is past retirement age when disabled. Assume the taxpayer must choose between (1) benefits under an occupational disability statute or (2) regular retirement benefits. Assume further that monthly payments under the workers' compensation statute would equal 50 percent of the taxpayer's final monthly salary of $4,000 – or $2,000 per month. Assume payments under the regular retirement plan would be $3,000 per month. Under these facts, exclusion from gross income is available only if the taxpayer chooses the workers' compensation benefits of $2,000 per month. If instead the taxpayer chooses the regular retirement benefits of $3,000 per month, the benefits are entirely includable in gross income (except for recovery of any employee investment in the plan).

4. *Retroactive Reclassifications of Benefits*

The Service and the courts have generally refused to recognize the retroactive reclassification of benefits as workers' compensation when there was no error of fact in earlier years. For example, the Service refused to recognize a retroactive reclassification by a taxpayer who voluntarily chose regular retirement benefits over workers' compensation benefits – even though the taxpayer was unaware of their different treatment under the tax law.[113] Similarly, the Tax Court refused to recognize the retroactive conversion of a non-occupational disability statute into a dual-purpose statute when the sole purpose of the conversion was to reduce the prior-year taxes of employees.[114] On the other hand, the Service has allowed taxpayers to give retroactive effect to corrections of erroneous employer records or misperceived facts in prior years, provided those prior years are not barred by the statute of limitations.[115]

5. *Conversion to Retirement Benefits*

Excludable workers' compensation benefits received under an occupational disability statute may convert to regular retirement benefits includable in gross income when a taxpayer reaches retirement age. Whether that happens depends largely on whether the employer recomputes the benefits based on age, service, or employee contributions.[116] Nevertheless, the applicable case law is a bit unsettled.

In three Tax Court memorandum decisions dealing with this issue,[117] the facts were essentially the same. A taxpayer, employed as a city firefighter or police officer, received payments under an occupational disability statute that were excludable from gross income as workers compensation. However, in each case, the city subsequently recomputed the taxpayer's benefit payments when the total of the taxpayer's years of service and years of disability equaled the years of service normally required for regular retirement benefits. The recomputed payments were essentially equal to the regular retirement payments the taxpayer would have received if he had continued to work during his years of disability.

The Tax Court held in each of these three cases that the recomputed payments were not excludable as workers' compensation since they were based on years of service. The court held that the payments were instead taxable in their entirety as regular retirement benefits. In one of the cases, the Tax Court expressly distinguished earlier revenue rulings that had allowed partial workers' compensation exclusions.[118] Unlike in those earlier rulings, the statutes in these cases did not provide for a minimum guaranteed amount payable without regard to age, length of service, or employee contributions.

The Sixth Circuit affirmed one of the three cases, providing little additional comment.[119] However, another of the three cases was appealed to the Ninth Circuit, which reversed the Tax Court and held that the recomputed payments were excludable from gross income as workers' compensation. The Ninth Circuit court concluded that the years of disability were not years of service for purposes of the exclusion. Therefore, the recomputed payments were not based on years of service, but rather were based on the time elapsing from the employee's date of hire. The court further stated that the city could not have shifted the taxpayer to its regular retirement plan since that plan required years of actual service that the taxpayer had not accumulated.[120]

Unfortunately, it is unclear whether the court thought that the years of disability did not qualify as years of service (1) because they could never qualify as such under the regulations or (2) because the city did not formally credit them as such.

6. *Tax Treatment of Nonqualifying Benefits*

The cases and rulings have not definitively prescribed the tax treatment of benefits putatively paid under an occupational disability statute that nevertheless fail to qualify as excludable workers' compensation benefits. As previously noted, benefits might fail to qualify for the exclusion in whole or in part because they are erroneously determined or because they are based on age, length of service, or employee contributions.

For example, the Service has impliedly held that, if a retiree's benefits based on age, service, or contributions exceed benefits qualifying as workers' compensation, the excess is taxable as sourced disability benefits (discussed previously in this Article).[121] On the other hand, the cases described under the immediately preceding caption treated payments based on age or service as regular retirement benefits. The courts in those cases did not even consider the possibility that the nonqualifying payments might instead be sourced disability payments.

Despite the absence of clear authoritative guidance, it does seem appropriate to treat nonqualifying benefits as regular retirement benefits if it is apparent the benefits were intended as a substitute for retirement benefits. For example, the Service and courts should treat as retirement benefits any nonqualifying benefits that simply offset otherwise available retirement benefits. On the other hand, it seems most reasonable to treat nonqualifying benefits as sourced disability benefits if the taxpayer would not have otherwise qualified for regular retirement benefits – or to the extent the nonqualifying benefits are in excess of retirement benefits otherwise available.

Of course, if an employer makes all the contributions to disability and retirement plans for employees, benefits not qualifying as workers' compensation are generally fully includable in employee gross income regardless of how the benefits are classified.[122] The classification will normally assume significance only if the plan or plans paying the benefits have received employee contributions. In that event, the *includable* portions of *sourced disability benefits* generally depend on the relative amounts of contributions by the employer and employees over a specified period (as discussed previously in this Article).[123] By contrast, the *excludable* portions of *regular retirement benefits* generally depend on the total plan contributions previously made by the recipient employee.[124]

B. Payments for Loss of Limbs, Disfigurement, Etc.

Certain disability payments for disfigurement, or loss (or loss of use) of a member or function of the body, are excludable from gross income even if attributable in whole or in part to employer contributions. However, a taxpayer must receive the payments under an employee plan.[125] The payments must be for a permanent injury (*i.e.*, one reasonably expected to continue for the rest of the taxpayer's life).[126] The amount of the payments must be based on the nature of the injury and must vary with the type of injury (*e.g.*, $xxx for loss of an arm, $yyy for loss of an eye, etc.).[127] The amount of the payments must not be based on the length of the period the taxpayer is absent from work[128] or on the taxpayer's lost wages or diminished earnings capacity.[129]

Loss (or loss of use) of a member or function of the body includes the loss (or loss of use) of an appendage of the body, the loss of an eye or ear, the loss of most of the vision of an eye, and the loss of most of the hearing in an ear. Such losses also include the destruction of a function of the immune system by an HIV infection or total disability due to terminal cancer.[130]

However, these losses do not include the mere partial diminishment of a function of the body. That is, they do not include a partly diminished heart function due to a heart attack or a partly diminished back function due to a back injury.[131] Nor do they include an existing condition that could lead to a future loss of bodily function. For example, they do not include hypertension (high blood pressure) that might cause a future loss of bodily function.[132]

Although the meaning of "disfigurement" is not entirely clear, the term is subject to a reasonable interpretation taking into account the particular circumstances.[133] Thus, for example, the term should include any severe scarring of the face that a plastic surgeon cannot correct.

The exclusion described here also applies to amounts received for injuries suffered by the taxpayer's spouse or dependents.[134] However, the exclusion does not apply to amounts received because of the taxpayer's death.[135] In no event does an amount received for bodily loss or disfigurement reduce a taxpayer's deductions for medical expenses, even if the taxpayer uses the amount received to pay medical expenses.[136]

C. Payments for Injuries Caused by Terrorists or the Military

Disability benefits are nontaxable if paid for injuries directly attributable to (a) "terroristic" actions or (b) "military" actions of the United States, its allies acting in concert with the U.S. military, or any multinational force that includes the U.S. military. Terroristic actions include only those directed against the United States or its allies. Military actions include only those (other than training exercises) that are in response to violence or aggression (or threats of such) against the United States or its allies.[137] Taxpayers may rely on the Service's published determination that an event constitutes a terroristic or military action.[138]

Unlike the other disability provisions of the Code, the exclusion for terroristic or military action refers to "injuries" but not to "sickness."[139] It is difficult to fathom what to make of that. It would seem, though, that injuries should largely encompass sicknesses. That is, a taxpayer with a disease or malady appears to have sustained harm or damage (*i.e.*, an injury). Indeed, few would doubt that a disease contracted from a terrorist's biological agent would qualify as an injury.

In addition, a taxpayer must incur the injuries as a "direct result" of the terroristic or military action. Although the precise parameters of that requirement must await future court decisions, it is unlikely the exclusion would apply to injuries merely proximately related to the terroristic or military action. For example, the exclusion would probably not be available to a worker involved in cleanup operations after a terroristic or military action unless the injury was one resulting directly from the action (such as a booby trap set by a terrorist).[140]

D. Payments to Certain Military Personnel and Others

Generally, a disabled U.S. military retiree is entitled to retired pay from his or her military branch equal to the larger of amounts based on (1) length of service or (2) percentage of disability.[141] The entire amount of any U.S. retired pay based on percentage of disability constitutes disability retired pay. Even if a taxpayer receives retired pay based on length of service because it is a larger amount, the pay is disability pay to the extent of the smaller amount based on percentage of disability.[142] Nevertheless, even though a taxpayer receives disability retired pay, it is excludable from gross income only if it satisfies the additional requirements discussed immediately below.

Disability payments to former military personnel and certain other government employees are excludable from gross income if they are one of the following:[143]

1. Pension, annuity, or similar payments[144] for "combat-related" injuries or sickness from active service in

a. the armed forces *of any country*,

b. the National Oceanic and Atmospheric Administration, or

c. the Public Health Service.

2. Disability annuity payments for "combat-related" injuries under section 808 of the Foreign Service Act of 1980.[145]

Combat-related injuries or sickness mean those (1) directly resulting from armed conflict, (2) incurred while engaging in extrahazardous service, (3) suffered under conditions simulating war, or (4) caused by an instrumentality of war.[146] However, a taxpayer's injuries or sickness need not be combat-related if the taxpayer was entitled to receive some of the disability payments before September 25, 1975. Nor are they required to be combat-related if, on September 24, 1975, the taxpayer was a member of one of the organizations described above (or had a binding contract to become a member).[147]

Taxpayers may not apply the military exclusion to disability payments received from civilian employment, even if their underlying disabilities are attributable to injuries or sickness incurred in military service. In denying such exclusions, the courts have focused on the general purpose of civilian plans to cover a much broader category of disability.[148] A similar analysis prevents application of the military service exclusion to social security disability benefits (though the usual social security exclusion may be available).[149]

Nor does an injury or illness convert *active duty* military pay into disability pay that is excludable from gross income – except in very limited circumstances.[150] Specifically, a taxpayer may exclude all or a designated portion of active duty pay only if the pay accrues while the taxpayer is hospitalized for an injury or sickness incurred in a combat zone. This limited exclusion is available only for as long as combat activities continue in the zone, and for approximately two years thereafter.[151]

Payments to survivors of a qualifying individual are generally also excludable from gross income[152] – but not if paid under the U.S. Armed Forces Retired Serviceman's Family Protection Plan or Survivor Benefit Plan[153] or under the Foreign Service Retirement and Disability System.[154]

1. *Retroactive Corrections and Tax Refunds*

A military retiree may be able to obtain a refund of taxes by first obtaining a correction of military records that retroactively changes his or her retired pay to excludable disability pay.[155] Even if the statute of limitations has run on earlier tax years, the retiree may be able to recover from his or her military branch (but not the Service) at least the income taxes originally withheld from his or her retired pay.[156]

2. *Disability Benefits from Department of Veterans Affairs*

Disability benefits paid by the U.S. Department of Veterans Affairs (VA) to a taxpayer or his or her survivors are excludable from gross income (even if the taxpayer's disability is not combat-related).[157] Similarly, retired pay received from the U.S. military is excludable to the extent the taxpayer could successfully apply for and receive the payments instead from the VA.[158]

If a taxpayer waives military retired pay to qualify for nontaxable VA benefits, the waived amount reduces the taxpayer's nontaxable military disability pay before reducing taxable pay.[159] On the other hand, if a VA award is retroactive, the taxpayer may be entitled to tax refunds attributable to the resulting conversion of taxable military pay to nontaxable VA benefits for years not closed by the statute of limitations.[160] In no event though will a VA award allow a taxpayer to exclude from gross income any portion of a so-called "readjustment payment" received upon termination of military service to ease transition to civilian life.[161]

E. Disability Benefits Paid for Wrongful Acts (Torts)

Disability payments for "personal physical injuries or sickness" caused by wrongful acts of others (torts) are generally excludable from gross income if paid as damages in a lawsuit, or as damages in settlement of an actual or threatened lawsuit.[162] The personal physical injuries or sickness must have directly caused the damages (whether the damages are physical, mental, or economic in nature).[163] In the case of a settlement, the taxpayer must specifically show that "(1) there was an underlying claim sounding in tort; (2) the claim existed at the time of the settlement; (3) the claim encompassed [personal physical injuries or sickness]; and (4) the agreement was executed 'in lieu' of the prosecution of the tort claim and 'on account of' the [personal physical injury or sickness] . . . ."[164]

The damages are excludable whether received periodically or in a lump sum.[165] However, punitive damages are not excludable unless paid under certain grandfathered wrongful death state laws allowing *only* punitive damages.[166] Damages for emotional distress are excludable if the emotional distress is directly attributable to a physical injury or sickness.[167] However, the Code provides that other damages for emotional distress are excludable only to the extent they do not exceed medical expenses required to treat the emotional distress.[168] For this purpose, emotional distress "includes symptoms (*e.g.*, insomnia, headaches, [and] stomach disorders) which may result from such emotional distress."[169]

F. Structured Settlements of Disability Disputes

If a taxpayer receives a nontaxable lump-sum disability payment from an actual or threatened lawsuit or workers' compensation claim, income subsequently earned on the taxpayer's investment of the lump sum is nevertheless generally includable in gross income. If, however, the taxpayer receives the nontaxable damages or settlement amount instead as periodic future payments, the payments will remain entirely nontaxable even though they include an inherent interest element attributable to the delayed payment.[170]

Nevertheless, for different reasons, the taxpayer and the obligor may find a periodic payment arrangement unappealing. The taxpayer may be reluctant to rely on the credit of the obligor over an extended payment period. The obligor may be reluctant to forgo an immediate deduction for payment of the liability and instead take deductions over the future years of periodic payments.[171]

The parties may however find a solution to these problems in a so-called "structured settlement." In a structured settlement, the obligor will generally pay an insurance company or other entity to assume the obligation to make periodic payments to the taxpayer. [172] The assuming entity will generally purchase an annuity to fund the entity's assumed obligation (without giving the taxpayer any ownership or security interest in the annuity).[173] Although the obligor and the assuming entity must satisfy stringent statutory requirements to make the arrangement effective, the end-result is that the obligor obtains an immediate deduction for payment of its liability and the taxpayer receives totally nontaxable periodic payments.[174]

By way of illustration, the U.S. government established structured settlements for victims of the September 11, 2001, terrorist attacks, and for surviving family members. Under the arrangements, victims (including survivors) agreed to waive their claims in return for fixed or determinable periodic payments. The government then paid assignment companies to assume the obligations to the victims. The assignment companies used the government's payment to purchase annuities to fund the victims' payments. The companies owned the annuities, and the victims had no ownership or security interest in them that might trigger the constructive receipt or economic benefit doctrines. The Service ruled the payments to the victims were totally excludable from gross income as damages received for personal physical injuries or sickness.[175]

IV. POTENTIAL CONFLICTS BETWEEN THE CODE'S DISABILITY AND SOCIAL SECURITY PROVISIONS

Social security disability benefits are generally taxable in the same way as regular social security retirement benefits. Consistent with this treatment, Congress and the courts have clearly favored the social security provisions of the Code over the disability provisions whenever a potential conflict exists. For example, the Code provides that workers' compensation benefits that reduce social security benefits (or that reduce tier 1 railroad retirement benefits) are taxable as social security benefits.[176]

In addition, the courts have thus far uniformly held that the disability provisions of the Code do not override the social security provisions:

1. The "sourced disability" provisions do not override social security provisions since the federal government does not pay social security disability benefits under an employee plan or as insurance benefits.[177] For the same reason (and for other reasons as well), the exclusion for payments for loss of limbs, loss of bodily function, or disfigurement is not applicable to social security benefits.[178]

2. The workers' compensation provisions of the Code do not apply to social security disability benefits since the benefits are not limited to employees who suffer injury or sickness in the course of employment.[179]

3. The exclusion of benefits for injuries or sickness incurred in active military service does not apply to social security benefits since the government pays social security benefits for general inability to work and not for any specific type of injury or sickness.[180]

The courts have not addressed the question of whether a taxpayer may exclude social security disability benefits under provisions applicable to injuries caused by terrorist or military actions.[181] However, as noted, the Second Circuit reasoned that the disability exclusion for active military service does not apply because the government pays social security disability benefits for mere inability to work, and not "for" or "on account of" military injury or sickness.[182] Thus, a court would also likely find that social security benefits are not (in the words of the applicable Code section) "attributable to" injuries resulting from terrorist or military actions.[183]

V. TREATMENT OF INTEREST, MEDICAL EXPENSES, AND ATTORNEY'S FEES IN DISABILITY DISPUTES

Interest income recovered in a disability lawsuit or settlement is taxable even though the underlying disability benefits are nontaxable.[184] Furthermore, an award or settlement that does not allocate a reasonable amount to recovered medical expenses is taxable to the extent of previously allowed deductions for the expenses. If an award or settlement does expressly allocate a reasonable amount to recovery of medical expenses, only the allocated amount is taxable (to the extent of previously allowed deductions).[185] If an award or settlement allocates a specific amount to *future* medical expenses, that amount is not taxable – but the future medical expenses are not eligible for deduction until they exceed the amount allocated.[186]

An award of attorney's fees is taxable only to the extent the fees relate to the recovery of interest income, taxable disability benefits, or other taxable items.[187] In the absence of persuasive evidence to the contrary, a taxpayer determines the taxable portion of an award of attorney's fees by multiplying the fee award by a fraction. The numerator of the fraction is the taxable portion of the recovery (exclusive of the award for attorney's fees). The denominator is the entire amount recovered (exclusive of the award for attorney's fees).[188] The taxpayer may then take a miscellaneous itemized deduction for the portion of the attorney fee expense allocable to taxable damages – subject to the usual limitations on such deductions.[189]

For example, assume a taxpayer paid attorney's fees of $75,000 in a lawsuit to recover nontaxable disability benefits of $225,000 and interest on the unpaid benefits of $25,000. Assume the court also awarded the taxpayer a reimbursement of the full amount of her attorney's fees of $75,000. Then the interest of $25,000 is taxable, and $7,500 of the reimbursement for attorney's fees is taxable.

The taxpayer computes the $7,500 taxable portion of the attorney's fee award by multiplying the total $75,000 fee award by ten percent. That percentage is equal to the $25,000 of taxable interest divided by the $250,000 sum of taxable interest and nontaxable disability benefits. The actual payment of the attorney's fees allocable to the taxable items (*i.e.*, $7,500) is then deductible as a miscellaneous itemized deduction – subject to the usual limitations on such deductions. The result is the same even if the taxpayer's attorney has the right to take a portion of the damages directly – whether under a contingent fee arrangement or some other kind of arrangement.[190]

A taxpayer will of course want to try to allocate damages to nontaxable items to the extent possible. However, the Service and courts will generally disregard an unreasonable allocation.[191]

VI. DISABLED OR ELDERLY TAX CREDIT

A taxpayer may be entitled to a disabled or elderly tax credit if the taxpayer or his or her spouse is unable to work because of disability, or is age 65 or older.[192] A qualifying disability is one preventing substantial gainful employment that is likely to last at least twelve months or until death.[193] Unfortunately, the credit is potentially available only to very low-income taxpayers, specifically to taxpayers with adjusted gross income less than the following:[194]

1. $17,500 if single.

2. $20,000 if married filing a joint return and only one of the taxpayer or his or her spouse is retired or disabled.

3. $25,000 if married filing a joint return and both the taxpayer and his or her spouse are retired or disabled.

4. $12,500 if married filing a separate return and the taxpayer lived apart from his or her spouse for the entire tax year.

5. $0 if married filing a separate return and the taxpayer did not live apart from his or her spouse for the entire tax year.

Even if adjusted gross income is less than the amount indicated above, a taxpayer under 65 is not entitled to the credit unless he or she receives includable disability income. Furthermore, the taxpayer may not be entitled to some or all of the credit if he or she receives nontaxable payments from the Social Security Administration or the Department of Veterans Affairs.[195]

VII. SUMMARY

Some disability benefits are entirely tax-exempt. Other disability benefits are wholly or partially includable in gross income depending on the source of their funding.

A. Sourced Disability Benefits

Sourced disability benefits are includable in gross income to the extent their source of funding is employer contributions previously excluded from employee gross income. If such excludable employer contributions are the source of all the funding, the disability benefits are entirely includable. If the employer makes no such excludable employer contributions, the disability benefits are entirely nontaxable. If the excludable employer contributions provide only part of the funding, only a corresponding portion of the benefits is includable. Benefits are taxable in this manner even if paid to a laid-off, terminated, or retired employee.

1. *Contributions by Both Employer and Employees*

The method for determining the includable portion of sourced disability benefits only partially funded by an employer differs depending on whether the plan consists of an individual disability insurance policy, a group disability insurance policy, or uninsured coverage. The percentage of disability payments includable in gross income under an individual insurance policy is the same as the percentage of total premiums contributed by the employer. The percentage of disability payments includable under a group insurance policy or a funded uninsured plan is generally the same as the percentage of the total contributions made by the employer during a specified period of years.

There is, however, some uncertainty regarding identification of the policy years used to compute the includable percentage of payments under an individual or group insurance policy.

2. *More than One Class of Employees*

If employee or employer contributions to a plan differ for different classes of employees, a taxpayer or employer must try to determine the employer contribution percentage separately for each class. Those employees providing a higher proportion of total contributions for their benefits will have a substantial stake in the separation of the classes.

3. *More than One Type of Benefit*

If a plan provides both disability benefits and other types of benefits, the taxpayer or employer must allocate employer and employee contributions among the various benefit categories. A plan providing retirement benefits must allocate contributions in accordance with the terms of the plan or, in the absence of such terms, must cover the cost of disability benefits with employer contributions and related earnings before applying employee contributions. Other plans must allocate contributions in accordance with the plan's actual application of the contributions, or if that is not determinable, must allocate the contributions proportionately.

4. *Election to Make Taxable Contributions*

Some plans allow an employee to make an election to bear the full cost of disability insurance coverage on an after-tax basis – thus making any ultimate disability payments nontaxable. Although there does not appear to be any express authority allowing a similar election for a funded uninsured plan, the rationale for allowing the election for an insured plan appears also to provide some support for an election for an uninsured plan. A taxpayer will generally find it advantageous to make an available election if the amount of the disability benefit remains unchanged after the election. However, the election decision becomes more difficult if the plan provides smaller disability payments when the payments are nontaxable.

5. *Conversion to Retirement Benefits*

Disability benefits may become taxable as retirement benefits when a disabled taxpayer reaches retirement age. From a planning standpoint, the conversion might be beneficial if a larger portion of retirement benefits is nontaxable. However, the conversion should not be available, or required, to the extent the disability benefits exceed the retirement benefits the taxpayer would otherwise have been eligible to receive, or if the taxpayer would not otherwise qualify for retirement benefits. If a taxpayer has the right to choose between disability benefits and retirement benefits, the taxpayer may be able to argue successfully that the choice should be respected for tax purposes.

6. *Corrections of Employer Errors or Methodology*

A taxpayer appears to have little recourse against an employer who refuses to revise incorrect determinations of the taxable portions of disability payments. Instead, the taxpayer must generally pursue the matter with the Service, in the Tax Court, or in a suit for refund against the United States. Possible use of the state court system for this purpose would likely not obviate the need to convince the Service or a federal court that a revision is correct for federal tax purposes.

B. Exempt Disability Benefits

Tax-exempt disability benefits include disability payments (1) under workers' compensation acts or similar statutes (2) for disfigurement or loss of limbs or bodily function, (3), for injuries caused by terrorists or the military, (4) for combat-related injuries, and (5) under judgments or settlements for physical injury or sickness.

1. *Workers' Compensation*

Workers' compensation benefits for personal injuries or sickness occurring in the course of employment are generally excludable from gross income. The benefits are excludable even if the taxpayer is able to work in some other occupation, or if the benefits are received by survivors of the taxpayer. However, the exclusion does not apply to the extent a retiree's benefits depend on age, length of service, or prior contributions.

Amounts paid under a statute in the nature of a workers' compensation act (*i.e.*, an occupational disability statute) may qualify as workers' compensation. However, the statute must specifically limit payments to compensation for injuries or sickness incurred in the course of employment. A statute may be an occupational disability statute even though it incorporates a rebuttable presumption that a specific type of injury or sickness occurred in the course of employment. An *irrebuttable* presumption is more problematical since it could potentially allow employees to receive benefits for nonoccupational injuries or sickness.

An occupational disability statute will not fail merely because a governmental unit administers it so poorly that some employees receive undeserved or inflated disability awards. Rather, the court must examine each employee's individual situation to identify nonqualifying awards.

If a taxpayer's disability occurs after reaching retirement age, the taxpayer may be able to choose between (1) workers' compensation benefits and (2) regular retirement benefits. On the other hand, excludable workers' compensation benefits received under an occupational disability statute may automatically convert to regular retirement benefits when the taxpayer reaches retirement age.

The cases and rulings have not definitively prescribed the tax treatment of benefits that fail to qualify as workers' compensation though putatively paid under an occupational disability statute. Generally, though, it seems appropriate to treat the nonqualifying benefits as regular retirement benefits if it is apparent the benefits are intended as a substitute for retirement benefits. On the other hand, nonqualifying benefits should be treated as sourced disability benefits if the taxpayer does not qualify for regular retirement benefits, or to the extent the disability benefits are in excess of regular retirement benefits.

2. *Disfigurement or Loss of Member or Function of Body*

Certain disability payments for disfigurement, or loss (or loss of use) of a member or function of the body, are excluded from gross income. The payments must be for a permanent injury (*i.e.*, one reasonably expected to continue for the rest of the taxpayer's life). The amount of the payments must be based on the nature of the injury and must vary with the type of injury. The amount of the payments must not be based on the length of the period the taxpayer is absent from work or on the taxpayer's lost wages or diminished earnings capacity.

3. *Terrorist or Military Actions*

Disability benefits are excluded from gross income if paid for injuries directly attributable to (a) "terrorists' actions," or (b) "military actions" of the United States, its allies acting in concert with the U.S. military, or any multinational force that includes the U.S. military. Terrorists' actions include only those directed against the United States or its allies. Military actions include only those (other than training exercises) that are in response to violence or aggression (or threats of such) against the United States or its allies. Taxpayers may rely on the Service's published determination that an event constitutes a terrorist or military action. However, it is unlikely the exclusion will apply to injuries merely proximately related to a terroristic or military action.

4. *Military Disability Payments*

Some disability benefits paid by the military and certain other government agencies are excludable from gross income if paid for combat-related injuries or sickness. However, the injuries or sickness need not be combat-related if the taxpayer was entitled to receive some of the disability payments on or before September 25, 1975 – or if on that date the taxpayer was a member (or had a binding contract to become a member) of the military or government agency. In addition, a military retiree may be able to obtain a refund of taxes by first obtaining a correction of military records that retroactively changes his or her retired pay to nontaxable disability pay. Even if the statute of limitations has run, the retiree may be able to recover at least the income taxes originally withheld from his or her retired pay.

5. *VA Disability Payments*

All disability benefits paid by the Department of Veterans Affairs are excludable from gross income (whether or not a taxpayer's disability is combat-related). U.S. military retired pay is also excludable to the extent the taxpayer could successfully apply for and receive the payments instead from the VA. If a VA award is retroactive, the taxpayer may be entitled to tax refunds for prior tax years not closed by the statute of limitations.

6. *Tort Judgments or Settlements for Disability*

Disability benefits for physical injuries or sickness caused by the tortious acts of others are generally excludable from gross income if paid as damages in a lawsuit or settlement. However, a taxpayer may not exclude punitive damages or some types of damages paid for emotional distress. Thus, in a settlement agreement, a taxpayer will want to allocate damages to nontaxable items to the extent possible. Such an allocation must however be within reasonable bounds to survive challenge by the Service.

7. *Structured Settlements*

Structured settlements facilitate the exclusion from gross income of periodic disability payments resulting from an actual or threatened lawsuit or a workers' compensation claim. In a structured settlement, the obligor will generally pay an insurance company or other entity to assume the obligation to make periodic payments to the disabled taxpayer. If the parties satisfy stringent statutory requirements, the obligor obtains an immediate deduction for payment of its liability and the taxpayer receives totally nontaxable periodic payments.

C. Treatment of Social Security Disability Benefits

Social security disability benefits are generally taxable in the same way as regular social security retirement benefits. Consistent with this treatment, Congress and the courts generally favor the social security provisions of the Code over the unrelated disability provisions whenever a potential conflict exists.

D. Interest, Medical Expenses, and Attorney's Fees

Interest income recovered in a disability lawsuit or settlement is includable in gross income even though the underlying disability benefits are excludable. Recoveries of past medical expenses are includable to the extent previously deducted. Recoveries of future medical expenses are excludable, but actual payments of the expenses are not deductible.

An award of attorney's fees is includable only to the extent the fees relate to the recovery of interest income, taxable disability benefits, or other taxable items. The taxpayer may then take a miscellaneous itemized deduction for the portion of the attorney fee expense allocable to taxable damages – subject to the usual limitations on such deductions.

In a settlement agreement, a taxpayer will want to try to allocate an award of attorney's fees to nontaxable items to the extent possible. However, the Service and courts will disregard an unreasonable allocation.

[1] Retired Attorney and CPA; University of Illinois, B.A., 1959; Indiana University, J.D., 1965. Contact at www.retirement-taxplanning.com.

[2] I.R.C. § 86. *See infra* text accompanying notes 176 to 183.

[3] I.R.C. § 104(a)(3).

[4] H. Rep. No. 104-736 (1996); P.L.R. 1997-30-009 (Apr. 21, 1997).

[5] *Helvering v. LeGierse*, 312 U.S. 531 (1941).

[6] P.L.R. 2000-07-025 (Nov. 19, 1999); P.L.R. 2007-04-017 (Oct. 26, 2006).

[7] I.R.C. § 105(e).

[8] Reg. § 1.105-1(b).

[9] *Id. American Foundry v. Commissioner*, 536 F.2d 289 (9th Cir. 1976).

[10] *Caplin v. United States*, 718 F.2d 544 (2d Cir. 1983).

[11] I.R.C. §§ 104(a)(3), 105(a). Nevertheless, benefits paid under a state disability plan are taxable to the extent paid in lieu of state unemployment compensation. I.R.C. § 85(b); Reg. § 1.85-1(b)(1)(ii); *Wolfe v. Commissioner*, 63 T.C.M. (CCH) 2951, 1992 T.C.M. (P-H) ¶ 92,267.

[12] I.R.C. § 104(a)(3); Reg. § 1.104-1(d).

[13] I.R.C. §§ 104(a)(3), 105(a); Reg. §§ 1.104-1(d), 1.105-1(a).

[14] I.R.C. §§ 104(a)(3), 105(a), 105(e); Reg. §§ 1.104-1(d), 1.105-1(a), 1.105-5(a).

[15] *See supra* note 14.

[16] Reg. § 1.104-1(d); *Bouquett v. Commissioner*, 67 T.C.M. (CCH) 2959, 1992 T.C.M. (P-H) ¶ 94,212.

[17] I.R.C. § 104(a)(3); Reg. § 1.104-1(d); Rev. Rul. 2004-55, 2004-1 C.B. 1081.

[18] Reg. §§ 1.104-1(d), 1.105-1(a), 1.105-5(a); P.L.R. 1987-34-001 (Mar. 18, 1987).

[19] Rev. Rul. 1973-155, 1973-1 C.B. 50.

[20] I.R.C. §§ 104(a)(3), 105(a), 105(e); Reg. § 1.105-1(b).

[21] I.R.C. §§ 104(a)(3), 105(a), 105(e), 106(a); Reg. §§ 1.105-1(a), 1.105-5(a); *Bouquett v. Commissioner*, 67 T.C.M. (CCH) 2959, 1992 T.C.M. (P-H) ¶ 94,212.

[22] Reg. § 1.105-1(b); Rev. Rul. 2004-55, 2004-1 C.B. 1081.

[23] Reg. § 1.105-1(b), Example (2).

[24] Reg. § 1.105-1(c)(1). Regardless of the source of funding, disability benefits are taxable in their entirety if paid under Section 2(a) of the Railroad Unemployment Insurance Act for any sickness that is not due to on-the-job injury. I.R.C. § 105(i).

[25] Reg. § 1.105-1(d), (e).

[26] Reg. § 1.105-1(d)(1).

[27] *Id.*

[28] I.R.C. §§ 104(a)(3), 105(a); Reg. § 1.105-1(a).

[29] In the example provided by the regulations, it was not necessary to indicate whether the employer contribution ratio was determined for the year of receipt or the year of initial disability (and thereby resolve the ambiguity) since the ratio was the same for all years under the plan. Reg. § 1.105-1(d)(1).

[30] Reg. § 1.105-1(d)(2).

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] I.R.C. § 105(a).

[35] *See supra* note 34.

[36] The regulations and rulings freeze other factors that enter into the determination of the includable portion of disability payments. *Cf.*, Reg. § 1.105-1(a) (status as regular employee or self-employed individual permanently determined at time first entitled to disability payments); Rev. Rul. 1982-196, 1982-2 C.B. 53 (disabled employee remains employee for purposes of taxing disability benefits even if employment is later formally terminated).

[37] The example provided by the regulations does not indicate whether the year of receipt of the disability payments there involved was also the year of initial disability, and thus does not conclusively resolve the apparent ambiguity. Reg. § 1.105-1(d)(2). Compare Reg. § 1.105-1(e) for funded uninsured plans, which unambiguously refers to an inclusion ratio determined using relative employer and employee contributions for years “next preceding the year of receipt.”

[38] Reg. § 1.105-1(e).

[39] *Id.*

[40] Reg. § 1.105-1(e). Compare the more ambiguous provisions of Reg. § 1.105-1(d)(2) applicable to group insurance plans.

[41] Reg. § 1.105-1(c)(2).

[42] Rev. Rul. 2004-55, 2004-1 C.B. 1081. In this revenue ruling, the Service held that an employee may elect to transfer from one employee class to another employee class under

a disability plan requiring that the employee make the election prior to the effective year of transfer.

[43] *See, e.g.*, *Mich. State Employees Ass'n v. Marlan*, 608 F. Supp. 85 (W.D. Mich. 1984) (taxpayers sought to force their employer to use three proposed employment classes instead of one).

[44] Reg. § 1.105-1(c)(3).

[45] Reg. § 1.72-15(c)(2).

[46] *Id*. *Golden v. Commissioner*, 30 T.C.M. (CCH) 691, 1971 T.C.M. (P-H) ¶ 71,162; *Chosiad v. Commissioner*, 40 T.C.M. (CCH) 1305, 1980 T.C.M. (P-H) ¶ 80,408.

[47] Reg. § 1.72-15(c)(2), (f), Example (3).

[48] Reg. § 1.105-1(c)(3).

[49] *Mich. State Employees Ass'n v. Marlan*, 608 F. Supp. 85 (W.D. Mich. 1984).

[50] Rev. Rul. 2004-55, 2004-1 C.B. 1081.

[51] Reg. § 1.105-1(c)(2), (d).

[52] Reg. § 1.105-1(c)(2), (e).

[53] In fact, some employers will reimburse employees for the approximate amount of the additional tax payable because of the election. *See, e.g.*, P.L.R. 2002-04-021 (Oct. 22, 2001).

[54] I.R.C. §§ 104(a)(3), 105(a).

[55] Rev. Rul. 1982-196, 1982-2 C.B. 53; Rev. Rul. 1985-121, 1985-2 C.B. 56.

[56] Rev. Rul. 1985-121, 1985-2 C.B. 56.

[57] Publication 575. For a discussion of comparable conversions of workers' compensation benefits to regular retirement benefits, see *infra* text accompanying notes 116 to 120.

[58] *Cf.*, *Picard v. Commissioner*, 165 F.3d 744 (9th Cir. 1999) (police officer's nontaxable workers' compensation benefits, though reduced at retirement age, did not become taxable retirement benefits when the police officer did not qualify for benefits under the applicable retirement plan).

[59] See *infra* text accompanying notes 111 and 112 for a discussion of a taxpayer's choice of either workers' compensation or regular retirement benefits.

[60] I.R.C. §§ 104(a)(3), 105(g); Reg. §§ 1.72-15(g), 1.105-1(a).

[61] P.L.R. 1999-45-064 (Aug. 18, 1999).

[62] Reg. § 1.72-15(g).

[63] Reg. § 1.105-1(a).

[64] Under I.R.C. § 401(a) or § 403(a).

[65] Under I.R.C. § 457.

[66] I.R.C. §§ 3405(a)(1), 3405(e)(1)(B)(i), 3401(a)(12)(A), (B), (E).

[67] I.R.C. §§ 3405(b)(1), 3405(e)(1)(B)(i), 3401(a)(12)(A), (B), (E).

[68] I.R.C. § 3405(a)(2), (b)(2); Temp. Reg. § 35.3405-1T, Q&A D-26, Q&A D-22.

[69] Temp. Reg. § 35.3405-1T, Q&A D-32.

[70] Reg. § 31.3401(a)-1(b)(8)(i)*(a)*.

[71] I.R.C. §§ 104(a)(3), 105(g); Reg. § 1.72-15(g).

[72] I.R.C. § 3402(o); Reg. § 31.3401(a)-1(b)(8)(i)*(b)(1)*.

[73] I.R.C. § 3121(a)((4).

[74] I.R.C. § 104(a)(1).

[75] I.R.C. § 105(c).

[76] I.R.C. § 104(a)(5).

[77] I.R.C. § 104(a)(4).

[78] I.R.C. § 104(a)(2).

[79] *Kane v. United States*, 43 F.3d 1446 (Fed. Cir. 1994) (citing W. PAGE KEETON ET AL., PROSSSER AND KEETON ON THE LAW OF TORTS § 80 (5th ed. 1984)).

[80] Federal Employees' Compensation Act, Pub. L. No. 89-554, 80 Stat. 532 (1966).

[81] Longshoremen's and Harbor Workers' Compensation Act, ch. 509, 44 Stat. 1424 (1927); Reg. § 1.104-1(b).

[82] I.R.C. § 104(a)(1); Reg. § 1.104-1(b).

[83] Reg. § 1.104-1(b); Rev. Rul. 1972-44, 1972-1 C.B. 31; Rev. Rul. 1980-137, 1980-1 C.B. 36.

[84] Reg. § 1.104-1(b). Nevertheless, a taxpayer able to take benefits under either of two different workers' compensation acts may choose the act providing the larger amount of benefits and still exclude the entire amount from gross income. Rev. Rul. 1983-91, 1983-1 C.B. 38.

[85] Reg. § 1.104-1(b).

[86] *Id*.

[87] *See supra* note 79.

[88] Reg. § 1.104-1(b). An injury or sickness incurred in the course of employment will qualify even if it is merely an aggravation of a previous injury or sickness. Rev. Rul. 1985-104, 1985-2 C.B. 52.

[89] *Dyer v. Commissioner*, 71 T.C. 560 (1979).

[90] *Rutter v. Commissioner*, 760 F.2d 466 (2d Cir. 1985), *cert denied*, 474 U.S. 848(1985); *Gabriel v. Commissioner*, 80 T.C.M. (CCH) 568, 2000 T.C.M. (RIA) ¶ 54,093; Rev. Rul. 1981-47, 1981-1 C.B. 55.

[91] *Wallace v. United States*, 139 F.3d 1165 (7th Cir. 1998).

[92] *See supra* note 88.

[93] *Kane v. United States*, 28 Fed. Cl. 10 (1993), *aff'd*, 43 F.3d 1446 (Fed. Cir. 1994); *Neill v. Commissioner*, 17 T.C. 1015 (1951), *acq*. 1952-1 C.B. 3. However, in *Gabriel v. Commissioner*, 80 T.C.M. (CCH) 568, 2000 T.C.M. (RIA) ¶ 54,093, the court refused to give *retroactive effect* to a dual-purpose statute enacted solely to provide more favorable tax treatment for disability payments made in prior years.

[94] *Byrne v. Commissioner*, 84 T.C.M. (CCH) 704, 2002 T.C.M. (RIA) ¶ 54,978 (and cases cited therein).

[95] *Byrne v. Commissioner*, 84 T.C.M. (CCH) 704, 2002 T.C.M. (RIA) ¶ 54,978.

[96] Rev. Rul. 1985-105, 1985-2 C.B. 53.

[97] *Take v. Commissioner*, 804 F.2d 553 (9th Cir. 1986); *Gabriel v. Commissioner*, 80 T.C.M. (CCH) 568, 2000 T.C.M. (RIA) ¶ 54,093.

[98] *Take v. Commissioner,* 804 F.2d 553 (9th Cir. 1986).

[99] *Stanley v. United States*, 140 F.3d 890 (10th Cir. 1998).

[100] *Brown v. United States*, 890 F.2d 1329 (5th Cir. 1989); *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993).

[101] *Robinson v. Commissioner,* 102 T.C. 116 (1994), *aff'd*, *in part, reversed in part on other grounds*, 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996).

[102] In *Brown*, 890 F.2d at 1342, the court said, "The relevance of a state court's judgment to the resolution of a federal tax question will vary, depending on the particular tax statute involved *as well as the nature of the state proceeding that produced the judgment*." (emphasis added)

[103] *See Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993); *Estate of Hubert v. Commissioner*, 101 T.C. 314 (1993), *aff'd*, 63 F.3d 1083 (11th Cir. 1995), *aff'd*, 520 U.S. 93 (1997).

[104] *Youngblood v. Commissioner*, 89 T.C.M. (CCH) 832 (2005).

[105] *Fotis v. Commissioner*, 57 T.C.M. (CCH) 695, 1989 T.C.M. (P-H) ¶ 89,287.

[106] Reg. § 1.104-1(b).

[107] Rev. Rul. 1980-44, 1980-1 C.B. 34 (holding the excess amount dependent on age, service, or employee contributions is sourced disability income subject to Code § 105); Rev. Rul. 1985-104, 1985-2 C.B. 52; Rev. Rul. 1985-105, 1985-2 C.B. 53.

[108] Rev. Rul. 1985-104, 1985-2 C.B. 52.

[109] Reg. § 1.104-1(b).

[110] *Triplett v. United States*, 98-1 U.S.T.C. ¶ 50,206, 83 A.F.T.R.2d 1096 (N.D. Ca. 1998).

[111] I.R.C. § 104(a)(1); Reg. § 1.104-1(b).

[112] *Carlton v. United States*, 782 F.2d 173 (Fed. Cir. 1986).

[113] Rev. Rul. 1974-582, 1974-2 C.B. 34.

[114] *Gabriel v. Commissioner*, 80 T.C.M. (CCH) 568, 2000 T.C.M. (RIA) ¶ 54,093.

[115] Rev. Rul. 1974-582, 1974-2 C.B. 34; P.L.R. 1990-46-005 (Aug. 7, 1990).

[116] Rev. Rul. 1980-14, 1980-1 C.B. 33.

[117] *Mabry v. Commissioner*, 50 T.C.M. (CCH) 336, 1985 T.C.M. (P-H) ¶ 85,328; *Wiedmaier v. Commissioner*, 48 T.C.M. (CCH) 1350, 1984 T.C.M. (P-H) ¶ 84,540, *aff'd*, 774

F.2d 109 (6th Cir. 1985); *Picard v. Commissioner*, 74 T.C.M. (CCH) 83, 1997 T.C.M. (RIA) ¶ 97,320, *rev'd*, 165 F.3d 744 (9th Cir. 1999).

[118] *Picard, supra* note 117, and the revenue rulings cited in note 107, *supra*.

[119] *Wiedmaier v. Commissioner*, 774 F.2d 109 (6th Cir. 1985).

[120] *Picard v. Commissioner*, 165 F.3d 744 (9th Cir. 1999).

[121] Rev. Rul. 1980-44, 1980-1 C.B. 34. More specifically, the Service held that the excess might qualify for exclusion under then existing (but since repealed) Code § 105(d). That Code section provided a limited exclusion for disability payments received by a taxpayer who had not yet reached age 65. However, to qualify for the § 105(d) exclusion, the payments had to qualify first as sourced disability benefits.

[122] I.R.C. §§ 104(a)(3), 105(a), 402(a), 72(f).

[123] *See supra* text accompanying notes 26 through 40.

[124] I.R.C. §§ 402(a), 72(f).

[125] I.R.C. § 105(c). See *supra* text accompanying notes 7 through 10 for a discussion of the requirements a plan must satisfy.

[126] Reg. § 1.105-3.

[127] *Beisler v. Commissioner*, 814 F.2d 1304 (9th Cir. 1987); *Hines v. Commissioner*, 72 T.C. 715 (1979).

[128] Reg. § 1.105-3.

[129] *Hines v. Commissioner*, 72 T.C. 715 (1979); *Watts v. United States*, 703 F.2d 346 (9th Cir. 1983).

[130] Rev. Rul. 1963-181, 1963-2 C.B. 74; P.L.R. 1993-21-068 (Mar. 2, 1993). Compare Rev. Rul. 1974-603, 1974-2 C.B. 35, involving total disability due to blindness, distinguishing Rev. Rul. 1963-181 on grounds the payment in that ruling was determined "without regard to the period the employee is absent from work."

[131] *Hines v. Commissioner*, 72 T.C. 715 (1979); *West v. Commissioner*, 64 T.C.M. (CCH) 1108, 1992 T.C.M. (P-H) ¶ 92,617.

[132] *Watts v. United States*, 703 F.2d 346 (9th Cir. 1983).

[133] Reg. § 1.105-3.

[134] I.R.C. § 105(c)(1). For this purpose, a dependent is defined the same as for purposes of personal exemptions, except that (1) the dependent may have dependents of his or her own, (2) the dependent may file a joint return, and (3) there is no limit on the dependent's gross income. I.R.C. § 152(b)(1), (b)(2), (d)(1)(B).

[135] Reg. § 1.105-3.

[136] I.R.C. § 105(f); Reg. § 1.213-1(a)(3)(ii).

[137] I.R.C. §§ 104(a)(5), 692(c)(2), 692(c) (3).

[138] Rev. Proc. 2004-26, 2004-1 C.B.. 890.

[139] I.R.C. § 104(a)(5).

[140] Compare Code § 692(d)(4) that (for other purposes) defines a terrorist victim as one who dies from wounds incurred merely "as a result of" terrorist attacks – thus clearly covering taxpayers who die in rescue or recovery operations. H.R. Conf. Rep. No. 108-126: Jobs and Growth Tax Relief Reconciliation Act of 2003.

[141] 10 U.S.C. §§ 1401, 1402, 1402a.

[142] 10 U.S.C. § 1403.

[143] I.R.C. § 104(a)(4), (b).

[144] I.R.C. § 104(b)(3). For this purpose, a court has treated the payment of disability severance in a lump sum as similar to a pension or annuity. *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va. 1991), *action on decision* A.O.D. 1992-006.

[145] 22 U.S.C. § 4048.

[146] I.R.C. § 104(b)(3).

[147] I.R.C. § 104(b)(2)(A), (B).

[148] *Haar v. Commissioner*, 78 T.C. 864 (1982), *aff'd*, 709 F.2d 1206 (8th Cir. 1983); *Kiourtsis v. Commissioner*, 72 T.C.M. (CCH) 1438, 1996 T.C.M. (RIA) ¶ 96,534.

[149] *Reimels v. Commissioner*, 123 T.C. 245 (2004) aff'd, 436 F.3d 344 (2d Cir. 2006). *See infra* text accompanying notes 176 to 183.

[150] *Hernandez v. Commissioner*, 72 T.C. 1234 (1979).

[151] I.R.C. § 112.

[152] Rev. Rul. 1956-42, 1956-1 C.B. 54.

[153] 10 U.S.C. § 1431 et seq.; I.R.C. §§ 72(n), 104(a)(3), 105(a), 122(a) (elective contributions excluded from gross income and survivor's benefits included in gross income); Reg. §§ 1.104-1(e)(3), 1.122-1(d), Example (2), 1.122-1(e) (retiree's disability exclusion does not carry over to survivor's benefits).

[154] 22 U.S.C. § 4041 et seq.; Reg. § 1.104-1(e)(2).

[155] *Prince v. United States*, 119 F.Supp. 421, 127 Cl. Ct. 612 (1954).

[156] *Ray v. United States*, 453 F.2d 754 (Cl. Ct. 1972).

[157] 38 U.S.C. § 5301(a).

[158] I.R.C. § 104(b)(4).

[159] Reg. § 1.122-1(c)(3).

[160] *Strickland v. Commissioner*, 540 F.2d 1196 (4th Cir. 1976); *Sullivan v. United States*, 46 Fed. Cl. 480 (2000); Rev. Rul. 1978-161, 1978-1 C.B. 31.

[161] *Berger v. Commissioner*, 76 T.C. 687 (1981); Rul. 1980-9, 1980-1 C.B. 11.

[162] I.R.C. § 104(a)(2); Reg. § 1.104-1(c).

[163] *Commissioner v. Schleier*, 515 U.S. 323 (1995); *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *rev'd on other grounds*, *Commissioner v. Banks*, 543 U.S. 426 (2005).

[164] *Greer v. United States*, 207 F.3d 322, 327 (6th Cir. 2000) (restating the requirements established in *Commissioner v. Schleier*, 515 U.S. 323 (1995)).

[165] I.R.C. § 104(a)(2); Reg. § 1.104-1(c).

[166] I.R.C. § 104(a)(2), (c).

[167] H.R. Conf. Rep. No. 104-737, at 301 (1996), 1996-3 C.B. 741, 1041; P.L.R. 1999-52-080 (Sept. 30, 1999).

[168] I.R.C. § 104(a).

[169] H.R. Conf. Rep. No. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56.

[170] I.R.C. § 104(a)(1), (2).

[171] I.R.C. § 461(h)(1), (2)(C).

[172] I.R.C. §§ 130(a), 468B(b)(3).

[173] I.R.C. § 130(d).

[174] I.R.C. § 104(a)(1), (2); Reg. § 1.461-6; Rev. Rul. 1979-220, 1979-2 C.B. 74.

[175] Rev. Rul. 2003-115, 2003-2, C.B. 1052. The victims' payments were also excludable from gross income under Code § 139(f), as payments under Section 406 of the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 240 (2001).

[176] I.R.C. § 86(d)(3). *Mikalonis v. Commissioner*, 80 T.C.M. (CCH) 330, 2000 T.C.M. (RIA) ¶ 54,033.

[177] I.R.C. §§ 104(a)(3), 105(a); *Thomas v. Commissioner*, 81 T.C.M. (CCH) 1653, 2001 T.C.M. (RIA) ¶ 54,345.

[178] I.R.C. § 105(c), (e); Reg. § 1.105-5(a); *American Foundry v. Commissioner*, 536 F.2d 289 (9th Cir. 1976).

[179] I.R.C. § 104(a)(1); Reg. § 1.104-1(b); *Green v. Commissioner*, 91 T.C.M. (CCH) 858 (2006).

[180] *Reimels v. Commissioner*, 123 T.C. 245 (2004) *aff'd*, 436 F.3d 344 (2d Cir. 2006).

[181] I.R.C. § 104(a)(5).

[182] *Reimels v. Commissioner*, 436 F.3d 344, 348 (2d Cir. 2006).

[183] Code § 104(a)(5) provides the exclusion for "disability income attributable to injuries incurred as a direct result of a terroristic or military action . . . ."

[184] *Chamberlain v. United States*, 401 F.3d 335 (5th Cir. 2005); *Church v. Commissioner*, 80 T.C. 1104 (1983).

[185] I.R.C. § 104(a); Rev. Rul. 1975-230, 1975-1 C.B. 93.

[186] *Morgan v. Commissioner*, 55 T.C. 376 (1970); Rev. Rul. 1975-232, 1975-1 C.B. 94.

[187] *Johnson-Waters v. Commissioner*, 66 T.C.M. (CCH) 252, 1993 T.C.M. (RIA) ¶ 93,333; P.L.R. 2004-03-046 (undated).

[188] *Id*. MSSP: Lawsuits Awards and Settlements.

[189] I.R.C. §§ 62(a), 67(b), 212(1), 265(a)(1); *Church v. Commissioner*, 80 T.C. 1104 (1983); MSSP: Lawsuits Awards and Settlements.

[190] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[191] *Robinson v. Commissioner*, 102 T.C. 116 (1994), *rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996); *Johnson-Waters v. Commissioner*, 66 T.C.M. (CCH) 252, 1993 T.C.M. (RIA) ¶ 93,333; P.L.R. 2004-03-046 (undated).

[192] I.R.C. § 22(a), (b).
[193] I.R.C. § 22(e)(3).
[194] I.R.C. § 22(c)(2), (d), (e)(1).
[195] I.R.C. § 22(c)(3).