

MEMORANDUM OF LAW

DATE: March 29, 1991

TO: Larry Grissom, Retirement Administrator  
FROM: City Attorney  
SUBJECT: Taxability of Disability Retirement Benefits

In a memorandum dated January 22, 1991, you expressed interest in counseling employees on the general tax consequences of disability retirement benefits. Specifically, you asked whether there is a difference in the taxability of a safety member industrial or non-industrial disability versus a general member industrial or non-industrial disability benefit. In addition, you asked whether there is a difference in the taxability of industrial disability retirement versus a non-industrial disability retirement.

After reviewing the Internal Revenue Code (IRC), the Federal Tax Regulations and Revenue Rulings issued by the Internal Revenue Service (IRS), we conclude that there is no difference in the taxability of a safety member industrial or non-industrial disability versus a general member industrial or non-industrial disability. For tax purposes, general members and safety members are treated alike. There are differences, however, in the taxability of an industrial disability versus a non-industrial disability retirement. Non-industrial disability benefits are included in the recipient's gross income. They are subject to state and federal income tax. Industrial disability benefits are not included in the recipient's gross income. They are not subject to state and federal income tax.

If, however, the City Employees' Retirement System (CERS) member retiring on an industrial disability is also eligible for a service retirement which is greater than the disability retirement allowance, then only the portion of the retirement allowance attributable to the industrial disability retirement is tax exempt. The excess difference between the disability retirement allowance and the service retirement allowance is included in the retiree's gross income and subject to state and federal income tax. Our analysis follows.

ANALYSIS

Section 61(a) of the IRC provides that, "except as otherwise provided by law, gross income means all income from whatever source derived . . . ." Subdivision (1) specifically includes "compensation for services . . . ." Subdivision (11) specifically includes "pensions."

Section 104(a)(1) of the IRC provides that "amounts received under workmen's compensation acts as compensation for personal injuries or sickness" are not includable in gross income. Section 1.104-1(b) of the Federal Tax Regulations provides further clarification. It provides in pertinent part that: "Section 104(a)(1) excludes from gross income amounts which are received by an employee under a workmen's compensation act . . . or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment." (Emphasis added.)

Section 1.104-1(b) of the Federal Tax Regulations provides further that:

However, section 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or illness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a nonoccupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act . . . . (Emphasis added.)

Clearly, in light of the foregoing, the tax favored treatment of disability benefits is limited to an occupational injury or sickness i.e., industrial disability benefits. In addition, the

IRS has ruled that a statute is not in the nature of a workmen's compensation act unless it limits benefits to instances of work-related disability. Rev. Rul. 80-84; Rev. Rul. 83-77; Rev. Rul. 85-105.

San Diego Municipal Code (SDMC) section 24.0501 sets forth the requirements for an industrial disability for safety and general members of CERS. It provides: "Any member, including a safety member, permanently incapacitated from the performance of duty as the result of injury or disease arising out of or in the

course of his or her employment, shall be retired for disability with retirement allowance, regardless of age or amount of service."

This section complies with the requirements set forth in IRC section 104(a)(1). On its face, any member permanently incapacitated from the performance of duty as the result of injury or disease arising out of or in the course of employment is entitled to a disability retirement regardless of age or length of service. As such, the San Diego ordinance is a "statute in the nature of a workmen's compensation act." Any benefits paid under this section are excluded from the retiree's gross income. Rev. Rul. 85-105; Rev. Rul. 80-14; Rev. Rul. 80-44; Rev. Rul. 83-77.

SDMC section 24.0502 provides further that: "upon retirement for industrial or non-industrial disability, a member, including a safety member, who has attained the minimum age at which he may retire for service shall receive his service retirement allowance, if greater." According to the IRS, if the retiree is eligible for both an occupational disability retirement and a service-connected retirement and the statute provides that the retiree may elect to receive the greater benefit, then only that portion of the disability benefit allowable under the disability provision will be excluded from the retiree's gross income. Any excess benefit attributable to length of service is not excludable under IRC section 104(a)(1). It will be subject to state and federal income tax. Rev. Rul. 85-105; Rev. Rul. 80-14.

SDMC section 24.0503 sets forth the computation of benefits for a safety member industrial disability retirement. The computation of benefits for a general member industrial disability retirement is set forth in SDMC section 24.0504.1. Although the amount of benefits payable under these sections is quite different, the taxability is the same. Benefits paid under either section are excluded from the recipient's gross income.

The computation of benefits for a safety member non-industrial disability retirement are set forth in SDMC section 24.0503.1. Section 24.0505.1 sets forth the computation of benefits for a general member non-industrial disability retirement. Again, although the amount of benefits payable under these sections is different, they are treated alike for tax purposes. Benefits payable under either section are included in the recipient's gross income. As such, they are subject to state and federal income tax.

Finally, service retirement allowances for general members and safety members are set forth in SDMC sections 24.0402 and

24.0403, respectively. Although the amounts allowable under either section differ, they receive identical tax treatment. Benefits paid under either section are included in the recipient's gross income. As such, they are subject to state and federal income tax.

#### CONCLUSION

The pension received by a CERS member under SDMC sections 24.0503 or 24.0405.1 for an industrial disability is not included in the recipient's gross income under IRC section 104(a)(1) because these statutes are in the nature of a workmen's compensation act. Benefits paid under either of these sections qualify for the exemption from gross income as set forth in IRC section 104(a)(1) because the benefits are restricted to members with service-incurred disabilities.

All other retirement benefits, including the normal service retirement allowances for either general or safety members and any excess benefit paid to a retiree under the authority of SDMC section 24.0502 (the authority to receive a service retirement allowance if it is greater than the industrial disability allowance) are included in the recipient's gross income. As such, these benefits will be subject to state and federal income tax.

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By

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