

## MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: IRS Private Letter Ruling dated August 20, 2013

DATE: May 15, 2014

This memorandum only concerns federal taxation of disability retirement and death benefits. As we are all aware, superannuation retirement allowances are always subject to federal taxation. Conversely, contributory retirement allowances paid out under Chapter 32 are not subject to Massachusetts taxation. Thus, this memorandum is limited in scope only to issues involving *federal* taxation of disability and death benefits.

The Internal Revenue Service (“IRS”) has issued a Private Letter Ruling (“PLR”) to PERAC regarding the federal tax status of certain disability and death payments made by the systems. A Private Letter Ruling is defined on the IRS website as follows:

A private letter ruling, or PLR, is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer’s represented set of facts. A PLR is issued in response to a written request submitted by a taxpayer. A PLR may not be relied on as precedent by other taxpayers or by IRS personnel.

PERAC sent the request for the PLR on March 28, 2013 and received a response on August 20, 2013. The PLR is attached and is self-explanatory, although we will briefly summarize some important points below. Tax counsel has informed PERAC that PLRs are considered effective only from the date of issue. Accordingly, any corrections to tax status of payments that need be made by the boards need only be made from August 20, 2013 forward.

The attached PLR was the subject of a PERAC presentation at the October 2013 MACRS conference, and was distributed to all attendees at that time. This memorandum was not immediately forthcoming following the MACRS distribution because questions arose for which we needed to consult with our tax counsel.

This PLR answers some lingering questions regarding the taxability of certain Chapter 32 benefits, although most of the rulings will come as a surprise to no one as they are consistent with longstanding practice.



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**Short summary of the 8 answers the IRS has given us:**

**Question 1:** Ordinary disability retirement is includable in taxable income.

**Question 2:** Accidental disability retirement (pension portion) is not includable in taxable income. Also not includable in taxable income are any dependent allowances.

**Question 3:** Section 101 benefits paid to the survivors of accidental disability retirees are not includable in taxable income.

**Question 4:** Option C benefits paid to the survivors of accidental disability retirees are not includable in taxable income.

**Question 5:** Accidental disability retirement benefits (pension portion) awarded on the basis of one of the presumptions found at Chapter 32, Sections 94, 94A, or 94B, are not includable in taxable income. Similarly, Section 9 benefits paid to the survivors of those stricken under Sections 94, 94A, or 94B will also not be includable in taxable income.

**Question 6:** Section 9 survivor benefits will not be includable in taxable income. Dependent allowances for minor children will also not be includable in gross income.

**Question 7:** Survivor benefits paid under Section 100 will not be considered taxable income to the recipient. Section 100 benefits to children, upon the death of an eligible spouse, shall also be excluded from taxable income.

**Question 8:** The taxability of cost of living adjustments (COLAs) will be dependent upon the taxability of the underlying benefit from which they flow.

**A common theme, leading to a long sought ruling**

The annuity portion of a retirement allowance is always subject to taxation, but the taxability of other portions of a retirement allowance had been in question. This prompted PERAC to seek a ruling from the IRS.

As will readily be seen, both from reading the summary above and reading the PLR in its entirety, a common theme emerges: that the taxability for benefits for survivors will be the same taxability as the member enjoyed. Put another way, if a member's benefit was taxable, the survivor's benefit will be taxable. If a member's benefit was not taxable, the survivor's benefit will not be taxable. Similarly, COLA's will be subject to taxation only to the extent the underlying benefit was subject to taxation.

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Prior to this ruling, there had been a split among retirement boards regarding the taxability of an Option C benefit following a Section 7 retirement allowance. Similarly, many boards had included in federal income taxation the amounts payable to surviving spouses under Section 101. In both cases, it seemed including those benefits to survivors in taxable income was arguably the correct course to take, since, by the terms of both these sections of the statute, the member had not died of the cause for which he or she retired. However, the IRS makes clear, in its answers to **Question 3** and **Question 4**, that these benefits must not be includable in taxable income. **Question 8**, giving COLA's the tax character of their underlying benefit, emphasizes the taxation follows the primary benefit approach mandated by the IRS.

**A conclusion by analogy**

Nothing in the PLR addresses Section 101 benefits being received by the survivors of *ordinary* disability retirees. Following with the theme of the PLR, as the successor in interest to a Section 6 benefit, the Section 101 benefit payable to an ordinary disability retirement survivor will be included in taxable income. PERAC recognizes that this means that in any given board, two different survivors receiving Section 101 benefit would be taxed differently. However, this conclusion is inescapable because of the IRS approach regarding the tax character of a survivor's benefit following the taxation status of the original benefit.

**Not in the PLR**

PERAC did not ask, nor was it necessary for PERAC to ask, about scenarios involving the return of a member's annuity account in a lump sum. In all cases involving the disbursement of an annuity account, federal taxation will attach. It will always be a taxable event. The manner of a member's death will not transform money in the annuity account into a payment in the nature of Workers' Compensation.

**A question which has Arisen since the PLR's initial distribution in October**

Another common theme throughout this PLR is the consistent limitation on the amount of the benefit which will be excluded from taxable income. In regard to **Question 2**, for example, the phrase "up to 72% of the annual compensation at the time of disability" is used. As we are all well aware, an accidental disability benefit generally consists of "a yearly amount of pension equal to 72% of the annual rate of his regular compensation on the date such injury was sustained or such hazard undergone, or equal to 72% of the average annual rate of his regular compensation for the 12-month period for which he last received regular compensation, whichever is greater..." (G.L. c. 32, § 7(2)(a)(ii)). Since the answer to **Question 8** makes clear that COLAs are subject to the same tax status as the underlying benefit, to what can the IRS possibly be referring in its "exceeding 72%" language?

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A person might exceed the amounts described in this PLR if they receive retirement benefits as the result of a special bill, or if a surviving spouse is granted a Section 9 pension after their member spouse had received many years of COLAs.

#### **Surviving spouses in certain circumstances**

The phrase about not exceeding “72% of the annual rate of compensation of such member” could be problematic in the case of a surviving spouse whose member spouse has had numerous COLAs prior to his or her death. As we all know, if someone is retired for a while, the pension portion of their benefit will well exceed 72% of the annual rate of compensation.”

However, the fact that the IRS, in response to **Question 8**, has ruled that COLAs will be treated the same as the underlying disability retirement awarded, the COLAs and their tax free status will be inherited by the widow or widower at the member’s death.

#### **Special bills**

A separate memorandum regarding the tax status of disability and death payments received pursuant to special bills will soon be forthcoming.

We trust the foregoing will be of some assistance to you. If you have any further questions about this, please call John Parsons at Extension 912, or Judith Corrigan at Extension 904.

Attachment