

MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Applicability of IRS PLR Regarding Taxation

DATE: July 24, 2014

On May 15, 2014, PERAC issued a memorandum regarding questions which arise with respect to the effect of PERAC's August 20, 2013 IRS Private Letter Ruling ("PLR") on the taxation of certain death and disability benefits. Memorandum 17/2014 provides a summary of the PLR and its impact on certain benefits. This memorandum is concerned exclusively with the effect of the PLR on members who receive benefits as a result of a special bill.

As you are all aware, the Massachusetts Legislature passes special bills for the benefit of certain individuals. These bills often are in the nature of an augmented accidental disability retirement allowance, but may or may not reference Section 7 or other applicable sections of the statute. Our tax counsel advises when it comes to special bills, each individual bill needs to be examined to see how it is worded in order to determine the taxability of the benefit.

Special Bills—Benefit Paid by Reference Under Sections 7, 9 or 100

Tax counsel informs us that if the benefit in a special bill is being paid explicitly with reference to being paid as an accidental disability benefit under Chapter 32, Section 7, it would be treated as a Section 7 benefit – i.e., the pension portion, up to 72%, would be fully non-taxable; the annuity portion would be fully taxable. Any incremental special pension benefits would also be non-taxable, unless it is based on the member's age, years of service or employee contributions. Even though special bills are not covered by the PLR, we think this is a reasonable approach. Since the Legislature is just changing the amount of the benefit, not the nature of the benefit, and it is still being paid under Section 7, it is appropriate to treat it as a Section 7 benefit. The tax status of payments will be preserved so long as they are paid pursuant to Chapter 32, Section 7, (or Section 9, or Section 100) because these sections are statutory provisions that the IRS has approved for this special tax treatment.



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Special Bills—Benefit Paid Without Reference to Sections 7, 9 or 100

Occasionally, special bills may not explicitly reference Sections 7, 9 or 100. Tax counsel advises that in this case boards should determine whether the bill contains sufficient nexus to the provisions of Sections 7, 9 and 100. If the board concludes sufficient nexus exists such special bills may satisfy the standard to be treated as statutes "in the nature of workmen's compensation" (*i.e.*, be limited to providing benefits for death or disabilities that arose in the course of the employee's work), and thus be entitled to non-taxable treatment.

In the event that the retirement board concludes that the bill is not sufficiently grounded in the provisions of Sections 7, 9 and 100, tax counsel and PERAC believe it would be reasonable to report the benefits received under a special bill as "taxable amount not determined" under Box 2b of the Form 1099-R. We believe this is the least disruptive approach to members and would allow the individual member or beneficiary to claim whatever tax treatment they believe is appropriate on their individual tax returns. If a retirement system feels that a different tax reporting position should be taken, we would recommend that they consult with counsel to develop a reasoned approach to support that position. As the genesis of this guidance is the August 20, 2013 Private Letter Ruling from the IRS, and PLRs are considered effective only from the date of issue, we strongly recommend that any changes in the tax reporting of a member's benefit be prospectively implemented.

We understand you may have members or beneficiaries who continue to receive special benefits that are in this gray area, and you will be considering how to report those situations in future years. If deemed necessary by the board, we think the "taxable amount not determined" under Box 2b is the best possible approach given the circumstances.

It is clear that the best practice is to have all future special bills specifically mention the statute the member is being paid under in order to confirm the most favorable tax treatment. We advise boards to closely monitor local bills relative to their members and PERAC intends to do the same. Amendments could also be made to prior special bills in order to clarify the intended favorable tax treatment prospectively.

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.