Robert W. Wood
THE TAX LAWYER

IRS Warns That Pay On Disability Is Often Taxable: Here's How To Tell

Taxes 7/05/2017

What is taxed and what isn't can be confusing. In the case of disability pay, whether it is taxed or not usually depends on who paid for the disability insurance coverage. Perhaps your employer paid and you were covered as a fringe benefit. In that case, when you are disabled and the coverage kicks in, the benefits you receive are taxable. However, what if you paid for your disability insurance yourself, with after-tax dollars? In that case, the payments you later receive on disability are tax-free.

This may sound simple, but there are many tax disputes over these kinds of issues. Then, when you combine several tax rules, the complexity gets worse. That's what happened in *Fernandez v. Commissioner.* After her divorce, Shannon Fernandez received payments relating to her ex-husband's disability. Her husband had been receiving the payments tax-free since 1993 after he was disabled while working for the L.A. County Sheriff's Department. When *she* started receiving payments in 2007 after divorce, Shannon figured that the payments were *still* tax-free. However, the IRS and the Tax Court said otherwise and wanted her to pay tax on the payments.

Under the tax code, most payments to compensate you for being injured–including most legal settlements–may be taxable or not, depending on your injuries. If you have non-physical injuries like emotional distress, damage payments are taxed. Only if your injuries are physical are the compensatory payments tax-free. Yet there's an exception even here. In the case of worker's compensation payments for personal injuries, they are excluded from income under Section 104. Unlike other payments, the injuries don't even have to be physical. Thus, mental and emotional injuries covered by worker’s compensation count too.

What’s more, even retirement payments can be tax-free, if they are received under a worker’s compensation act. The IRS says so in Publication 15-A. Normally, of course, pensions can be socked away tax-free, and keep building tax-free. Yet when retirement payments commence, the retirement payments are normally taxed. The worker, the spouse or the former spouse are all taxed, assuming (in the latter case) that the pension benefits are divided in divorce. An order dividing a pension is called a qualified domestic relations order.

When Shannon’s divorce was finalized in 2007, she was awarded a percentage of her former husband’s retirement benefits. The disability retirement pay commenced when her husband became disabled. He received service-connected disability retirement benefits from 1993 until 2007. In that year, Shannon received $11,850 in payments. She received an IRS Form 1099-R from the L.A. Sheriff reporting it as taxable, but she didn’t include it on her tax return. The IRS audited and said it was taxable so Shannon went to Tax Court.

Shannon argued that the money was tax-free because she was the former spouse of the participant. She also argued she should step into his shoes and get the same tax treatment he did. After all, she and her husband got the payments tax-free all those years since 1993 while they were married. It was unfair to tax her once they were divorced. The IRS disagreed with every argument, saying her monies were retirement monies divided in divorce, so they were taxable.

The Tax Court agreed with the IRS. The retirement issue was resolved by statute, the court said. As to Shannon’s argument that she stepped into her ex’ shoes, the court said that *she* wasn’t the one who was injured. The injury exclusion has been in the tax code since 1918, said the court, but hers was a new argument not covered by the statute.

Sometimes, tax language in a legal settlement agreement can make a big difference in the tax treatment and how the IRS sees it. That’s one of the 10 things to know about taxes on legal settlements. However, the IRS isn’t bound by it.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.