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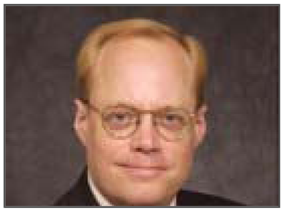

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THE TAX LAWYER

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Disability Pay: Some Taxable, Some Tax-Free

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What is taxed and what isn't can be confusing. When you combine several tax rules, the complexity gets worse. That's what happened to Shannon Fernandez when, after her divorce, she received payments relating to her ex-husband's disability. See *Fernandez v. Commissioner*.

Her husband had been receiving the payments tax-free since 1993 after being disabled while working for the L.A. County Sheriff's Department. When she started receiving payments in 2007 after divorce, Shannon figured they were ***still*** tax-free. However, the IRS and the Tax Court said no.

Under the tax code, worker's compensation payments for personal injuries are excluded from income. See IRC Section 104. Unlike other payments, the injuries don't even have to be physical—mental and emotional injuries covered by worker's compensation count too. Even retirement payments are excludable if they are received under a worker's compensation act. See Publication 15-A.

Pensions can be socked away tax-free and keep building tax-free. Yet when retirement payments commence, they're 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. See Care With Forms 1099 Helps Audit-Proof Tax Returns. 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 taxable. The Tax Court agreed with the IRS. The retirement issue was resolved by statute, it said.

As to Shannon's argument that she stepped into her ex' shoes, the court said she wasn't 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.

For more, see:

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