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SB 345

RONALD R. CUZZE
882 King Richard Ave.
Las Vegas, Nevada 89119

May 1, 2003

Senator Dennis Nolan
Legislative Building
401 S. Carson St.
Carson City, Nevada 89701

Dennis,

Per your request I am forwarding the New Jersey decision and the individual letter rulings that the IRS bases their determination on.

I believe your are correct in stating that the IRS could rule either way. If you approach this from the view that Ms. Bilyeu is taking the IRS will agree. On the other hand if you ask the IRS for a ruling based on the information that they provided to us, they would indeed state that disability is non-taxable.

Ms. Bilyeu is missing is the point that the IRS provided us the information on a personal level so we can recoup our taxes. The IRS has made this very clear. If the State of Nevada reports disability income as taxable, they will accept it. On the other hand if the State of Nevada and/or an individual reports or shows that the income is a result of disability they will not dispute it.

It is my opinion that Ms. Bilyeu is approaching this on a personal level, and not professionally. I would recommend that the LCB attorneys write the IRS for a ***"Letter Ruling"***, not PERS. If you ask the IRS if disability pay is tax exempt, instead of can the State declare disability pay taxable income; you will get the answer we desire.

Thanks again, I'll be in touch.

Sincerely,

Ron

Ron Cuzze

State of New Jersey
DEPARTMENT OF THE TREASURY
DIVISION OF PENSIONS AND BENEFITS
(609) 292-7524 TDD (609) 292-7718
www.state.nj.us/treasury/pensions

DONALD T. DIFRANCESCO
Acting Governor

Mailing Address:
PO Box 295
Trenton, NJ 08625-0295
Location:
50 West State Street
Trenton, New Jersey

PETER R. LAWRANCE
Acting State Treasurer

THOMAS P. BRYAN
Director

July 12, 2001

Ronald R. Cuzze
882 King Richard Ave.
Las Vegas, Nevada 89119-1372

RE: Taxation of Accidental Disability Retirement Benefits

Dear Mr. Cuzze:

This is in response to your letter dated June 20, 2001, in which you requested information on how the Division of Pensions and Benefits was able to classify accidental disability retirement benefits as a tax-exempt benefit.

The Division's longstanding policy had been to treat accidental disability benefits as taxable retirement benefits for federal tax purposes; however, in January of this year the Division obtained a legal opinion stating that accidental disability benefits paid from our state administered retirement systems meet the section 104(a)(1) criteria for excludability from federal tax. The opinion letter was issued by the law firm of Caplin and Drysdale, a firm that specializes in federal taxation. I have enclosed a copy of their opinion letter for your reference.

Based on this legal advise and research conducted by Division staff, the decision was made to change our reporting practice.

I hope you find this information useful. If you have any questions, please contact Mr. Tim McMullen, Supervisor of our Accounting Services Section at (609) 292-4542.

Sincerely,

John D. Megariotis
Assistant Director, Finance

Caplin&Drysdale
ATTORNEYS

Caplin & Drysdale, Chartered
One Thomas Circle, NW, Suite 1100
Washington, DC 20005
202-862-5000 202-429-3301 Fax
www.caplindrysdale.com

202-862-5021 Direct
mtd@capdale.com

January 11, 2001

PRIVILEGED AND CONFIDENTIAL
Mr. Thomas P. Bryan
Acting Director
Division of Pensions and Benefits
Department of the Treasury
State of New Jersey
CN-295
Trenton, New Jersey 08625-0295

Dear Mr. Bryan:

You have requested our opinion whether certain accidental disability benefits payable under four public retirement systems maintained by the State of New Jersey (the "State") are excludable from gross income under section 104(a)(1) of the Internal Revenue Code of 1986 (the "Code"). Specifically, you have asked whether the accidental disability benefits provided under New Jersey Statutes Annotated sections 43:16A-7 (the Police and Firemen's Retirement System), 53:5A-10 (the State Police Retirement System), 43:15A-43 and -46 (the Public Employees' Retirement System), and 18A:66-39.c and -42 (the Teachers' Pension and Annuity Fund) to employees participating in those systems (the "Participants") are excludable as benefits provided under statutes in the nature of workers' compensation acts. As discussed more fully below, we think those benefits should be excludable from gross income.

BACKGROUND

We understand the relevant facts to be as follows. The State maintains several statutory retirement systems for the benefit of employees of the State and its agencies, instrumentalities, and political subdivisions. Among those systems are the following: the Police and Firemen's Retirement System ("PFRS"), maintained under New Jersey Statutes Annotated, Title 43, Chapter 16A; the State Police Retirement System ("SPRS"), maintained under New Jersey Statutes Annotated, Title 53, Chapter 5A; the Public Employees' Retirement System ("PERS"), maintained under New Jersey Statutes Annotated, Title 43, Chapter 15A; and the Teachers' Pension and Annuity Fund ("TPAF"), maintained under New Jersey Statutes Annotated, Title 18A, Chapter 66. These four systems (collectively, the "Systems") are contributory defined benefit plans intended to satisfy the qualification requirements of Code section 401(a) applicable to governmental plans described in Code section 414(d).[1] The Systems generally are administered by the Division of Pensions and Benefits within the State's Department of the Treasury.

The primary purpose of PFRS, SPRS, PERS, and TPAF is to provide retirement income for each Participant. Thus, PFRS and SPRS were specifically established to provide "retirement allowances and other benefits." N.J.S.A. 43:16A-2 (PFRS); N.J.S.A. 53:5A-4 (SPRS). This retirement income generally is determined on the basis of the Participant's compensation and years of service. Additionally, each of the Systems provides a benefit for a

[1] The employee contributions required under the Systems are made under a Code section 414(h)(2) employer "pick-up" and therefore are treated as pre-tax employer contributions for federal income tax purposes.

Participant's accidental disability. The terms of those accidental disability benefits, which are broadly similar among the Systems, are described below.[2]

1. *The PFRS Accidental Disability Benefit*. PFRS provides that a Participant may be "retired on an accidental disability retirement allowance" if the Participant has been appropriately certified to be "permanently and totally disabled as a direct result of a traumatic event occurring during and as a result of the performance of his regular or assigned duties and that such disability was not the result of the [Participant's] willful negligence and that such [Participant] is mentally or physically incapacitated for the performance of his usual duty and of any other available duty" that might be assigned to the Participant. N.J.S.A. 43:16A-7(1). For these purposes, a permanent and total disability resulting from a cardiovascular, pulmonary, or musculo-skeletal condition that is not the direct result of a traumatic event occurring in the performance of duty is deemed not to be an accidental disability. N.J.S.A. 43:16A-7(4). Generally, the Participant must apply for the accidental disability benefit within five years of the traumatic event; however, the five-year requirement may be waived if the Participant shows that the disability was caused by the event and that the late application is attributable to delayed manifestation of the disability or other circumstances beyond the Participant's control. N.J.S.A. 43A:16A-7(1).

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[2] You have represented to us that the statutory provisions described below include all the material terms of the accidental disability benefits under the Systems.

The PFRS accidental disability benefit consists of two components: (1) an annuity that is actuarially equivalent to the Participant's contributions to PFRS; and (2) a pension that, when added to that annuity, provides a total benefit of two-thirds of the Participant's actual annual compensation at the time of the accident or at the time of the Participant's retirement, whichever is greater. N.J.S.A. 43:16A-7(2). PFRS also provides a survivor benefit to the beneficiary of a Participant who had been receiving an accidental disability benefit. N.J.S.A. 43:16A-7(3).

2. *The SPRS Accidental Disability Benefit*. SPRS provides that a Participant may be "retired . . . on an accidental disability retirement allowance" if the Participant has been appropriately certified to be "permanently and totally disabled as a direct result of a traumatic event occurring during and as a result of the performance of his regular or assigned duties and that such disability was not the result of the [Participant's] willful negligence and that such [Participant] is mentally or physically incapacitated for the performance of his usual duties . . . ." N.J.S.A. 53:5A-10.a. For these purposes, a permanent and total disability resulting from a cardiovascular, pulmonary, or musculo-skeletal condition that is not the direct result of a traumatic event occurring in the performance of duty is deemed not to be an accidental disability. N.J.S.A. 53:5A-10.d. Generally, the Participant must apply for the accidental disability benefit within five years of the traumatic event; however, the five-year requirement may be waived if the Participant shows that the disability was caused by the event and that the late application is attributable to delayed manifestation of the disability, continued employment

in a restricted capacity, or other circumstances beyond the Participant's control. N.J.S.A. 53:5A-10.a.

The SPRS accidental disability benefit consists of two components: (1) an annuity that is actuarially equivalent to the Participant's contributions to SPRS; and (2) a pension that, when added to that annuity, provides a total benefit of two-thirds of the Participant's final compensation. N.J.S.A. 53:5A-10.c. SPRS also provides a survivor benefit to the beneficiary of a Participant who had been receiving an accidental disability benefit. *Id.*

3. *The PERS Accidental Disability Benefit*. PERS provides that a Participant who has not attained the age of 65 may be "retired . . . on an accidental disability allowance" if the Participant has been appropriately certified to be "permanently and totally disabled as a direct result of a traumatic event occurring during and as a result of the performance of his regular or assigned duties" and that the disability was not the result of the Participant's willful negligence. N.J.S.A. 43:15A-43. For these purposes, a traumatic event occurring during the voluntary performance of regular or assigned duties at a place of employment before or after required work hours is deemed to occur during the performance of regular or assigned duties unless the performance of those duties violates any valid work rule or is otherwise prohibited by the employer. *Id.* However, a permanent and total disability resulting from a cardiovascular, pulmonary, or musculo-skeletal condition that is not the direct result of a traumatic event occurring in the performance of duty is deemed not to be an accidental disability. *Id.* Generally, the Participant must apply for the accidental disability benefit within five years of the traumatic event; however, the five-year requirement may be waived if the Participant shows that

the disability was caused by the event and that the late application is attributable to delayed manifestation of the disability or other circumstances beyond the Participant's control. *Id*

The PERS accidental disability benefit consists of two components: (1) an annuity that is actuarially equivalent to the Participant's contributions to PERS, with interest; and (2) a pension that, when added to that annuity, provides a total benefit of two-thirds of the Participant's compensation at the time of the accident. N.J.S.A. 43:15A-46. PERS also provides a survivor benefit to the beneficiary of a Participant who had been receiving an accidental disability benefit. *Id.*

4. *The TPAF Accidental Disability Benefit*. TPAF provides that a Participant who has not attained the age of 65 may be "retired . . . on an accidental disability allowance" if the Participant has been appropriately certified to be "permanently and totally disabled as a direct result of a traumatic event occurring during and as a result of the performance of his regular or assigned duties" and that the disability was not the result of the Participant's willful negligence. N.J.S.A. 18A:66-39.c. For these purposes, a traumatic event occurring during the voluntary performance of regular or assigned duties at a place of employment before or after required work hours is deemed to occur during the performance of regular or assigned duties unless the performance of those duties violates any valid work rule or is otherwise prohibited by the employer. *Id.* However, a permanent and total disability resulting from a cardiovascular, pulmonary, or musculo-skeletal condition that is not the direct result of a traumatic event occurring in the performance of duty is deemed not to be an accidental disability. *Id.* Generally, the Participant must apply for the accidental disability benefit within five years of the

traumatic event; however, the five-year requirement may be waived if the Participant shows that the disability was caused by the event and that the late application is attributable to delayed manifestation of the disability or other circumstances beyond the Participant's control. *Id.*

The TPAF accidental disability benefit consists of two components: (1) an annuity that is actuarially equivalent to the Participant's contributions to TPAF, with interest after January 1, 1956; and (2) a pension that, when added to that annuity, provides a total benefit of two-thirds of the Participant's compensation at the time of the accident. N.J.S.A. 18A:66-42. TPAF also provides a survivor benefit to the beneficiary of a Participant who had been receiving an accidental disability benefit and who retired on or after January 1, 1956. *Id.*

Although these statutory provisions of PFRS, SPRS, PERS, and TPAF setting out the accidental disability benefits differ in certain details, their essential terms are very similar. Each System requires that a Participant be permanently and totally disabled as a direct result of a traumatic event occurring in connection with the performance of regular or assigned duties. The Systems generally require that a Participant apply for the benefit within five years of the traumatic event but relax this requirement where there is a delayed manifestation of the disability (or other circumstances beyond the Participant's control) as long as the Participant can demonstrate that the disability was caused by the traumatic event. Under each System, the benefits comprise an annuity attributable to the Participant's own contributions and a pension that, when added to the annuity, yields a benefit stream equal to two-thirds of the Participant's previous compensation. Additionally, you have represented to us that the accidental disability

benefits under each System are offset by amounts payable under New Jersey workers' compensation statutes. *See* N.J.S.A. 43:16A-15.2.b (PFRS); N.J.S.A. 53:5A-38.1.b (SPRS); N.J.S.A. 43:15A-25.1.b (PERS); N.J.S.A. 18A:66-32.1.b (TPAF). *See also Conklin v. City of East Orange*, 73 N.J. 198 (1977) (construing PFRS).[3]

The payment of these accidental disability benefits under PFRS, SPRS, PERS, and TPAF is made by the Division of Pensions and Benefits. For federal income tax purposes, the Division of Pensions and Benefits generally has reported these payments as includible in the gross income of the Participants who receive them. However, several Participants have obtained private letter rulings from the Internal Revenue Service (the "Service") that these accidental disability benefits are excludable from gross income under Code section 104(a)(1).[4]

ANALYSIS

I. Overview of Section 104(a)(1)

Section 104(a)(1) of the Code generally excludes from gross income "amounts received under workmen's compensation acts as compensation for personal injuries or sickness . . . ." The exclusion is almost as old as the federal income tax itself. It was originally enacted under

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[3] Although each System also provides a survivor benefit, you have not requested our views on whether those survivor benefits are excludable from gross income.

[4] *See, e.g.*, Priv. Ltr. Rul. 200016012 (Jan. 21, 2000); Priv. Ltr. Rul. 199903039 (Oct. 7, 1999); Priv. Ltr. Rul. 9740020 (July 2, 1997); Priv. Ltr. Rul. 9716008 (Jan. 13, 1997); Priv. Ltr. Rul. 9647016 (Aug. 21, 1996); Priv. Ltr. Rul. 9639058 (June 25, 1996); Priv. Ltr. Rul. 9633024 (May 16, 1996); Priv. Ltr. Rul. 9625009 (Mar. 18, 1996); Priv. Ltr. Rul. 9624017 (Mar. 15, 1996); Priv. Ltr. Rul. 9619030 (Feb. 2, 1996); Priv. Ltr. Rul. 9416030 (Jan. 19, 1994); Priv. Ltr. Rul. 9245037 (Aug. 12, 1992); Priv. Ltr. Rul. 8925057 (Mar. 28, 1989); Priv. Ltr. Rul. 8924055 (Mar. 21, 1989).

the Revenue Act of 1918 because Congress doubted the constitutionality of including workers' compensation benefits in gross income. *See generally* Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 13.1.1 (3d ed. 1999); H.R. 767, 65th Cong., 2d Sess. at 9-10 (1918). "These doubts have long since dissipated, but the exclusion has persevered . . . ." Bittker & Lokken at ¶ 13.1.1.

The text of section 104(a)(1) narrowly applies to amounts received under workers' compensation acts, but the Service has expanded the scope of the exclusion considerably. Treasury Regulations section 1.104-1(b), first issued in 1956, provides that section 104(a)(1) applies to amounts received under a statute "in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness in the course of employment." The regulations also exclude from gross income amounts paid under a workers' compensation act to the survivor of a deceased employee. *Id.* However, the regulations limit the exclusion in two cases. Specifically, the regulations indicate that 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 where an employee retires because of an occupational disease or sickness. Also, section 104(a)(1) does not apply 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 or acts." *Id.* As interpreted by Treasury Regulations section 1.104-1(b), then, the exclusion from gross income under section 104(a)(1) has three elements: (1) the amount must be received under a workers' compensation act or a statute in the nature of a workers'

compensation act providing benefits for an occupational injury or illness; (2) the amount cannot be a retirement pension or annuity determined by reference to the recipient's age, length of service, or contributions; and (3) the amount cannot be in excess of the amount provided in the applicable workers' compensation law.[5]

II. Sources of Authority under Section 104(a)(1)

Code section 104(a)(1) and Treasury Regulations section 1.104-1(b) together set forth a terse rule for excluding accidental disability benefits paid under workers' compensation acts and statutes in the nature of workers' compensation acts. For this reason, much of the law under section 104(a)(1) has been set forth in court decisions and interpretive releases from the Service. Those interpretive releases generally take three forms: revenue rulings, general counsel memoranda, and private letter rulings. Of these, the latter two are technically without value as precedent and are not binding on the Service. *Stichting Pensioenfonds Voor de Gezondheid, Geestelijke en Maatschappelijke Belangen v. United States*, 129 F.3d 195, 200 (D.C. Cir. 1997) (general counsel memoranda "have no precedential value"), *cert. denied*, 525 U.S. 811 (1998); Code section 6110(k)(3) (private letter rulings "may not be used or cited as precedent").

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[5] The regulations also indicate that the exclusion does not apply to amounts received as compensation for a "nonoccupational" injury or sickness. However, because the Service interprets the requirement that benefits paid under a workers' compensation act or under a statute in the nature of a workers' compensation act be paid only for an occupational injury or illness, the restriction on nonoccupational injury or sickness does not constitute a distinct element of the exclusion for these purposes.

However, revenue rulings "are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose." Treas. Reg. § 601.601(d)(2)(v)(*d*); Rev. Proc. 89-14, 1989-1 C.B. 814. Therefore, "[t]axpayers generally may rely upon Revenue Rulings . . . in determining the tax treatment of their own transaction and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases." Treas. Reg. § 601.601(d)(2)(v)(*e*); Rev. Proc. 89-14, 1989-1 C.B. 814. If the facts applicable to a taxpayer's situation are substantially the same as those described in a revenue ruling, the Service will be bound by the revenue ruling with respect to the taxpayer, and the taxpayer may rely on the legal position of the ruling in the absence of subsequent legislation, regulations, court decisions, or other revenue rulings indicating a contrary result. *See, e.g., Stichting Pensioenfonds Voor de Gezondheid*, 129 F.3d at 198 ("Revenue Rulings bind both the Service and the taxpayer."). Thus, the many revenue rulings issued by the Service interpreting section 104(a)(1) constitute important precedent in determining the excludability of the PFRS, SPRS, PERS, and TPAF accidental disability benefits.[6] Although those rulings generally are not binding on the federal courts, they are binding on the Service. For this reason, the State and the Participants are permitted to rely on the positions set forth in those rulings.

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[6] Certain court cases misstate the effect of revenue rulings as binding on neither the courts nor the Service. *See, e.g., Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142 (5th Cir. 1971). Those decisions conflict with the Service's regulations.

III. Accidental Disability Benefits under the Systems

The accidental disability benefits provided by PFRS, SPRS, PERS, and TPAF generally satisfy the three elements of section 104(a)(1) and Treasury regulations section 1.104-1(b). For this reason, amounts paid under the Systems should be excludable from each Participant's gross income.[7]

1. *Statute "in the Nature of" Workers' compensation Act*

The provisions setting forth the PFRS, SPRS, PERS, and TPAF accidental disability benefits constitute statutes "in the nature of" workers' compensation acts and therefore satisfy the first element under section 104(a)(1). The essence of this first element is that benefits be provided only for disabilities incurred in connection with employment. Because the accidental disability benefits under the four Systems are strictly limited to disabilities of that kind, the statutes should be considered in the nature of workers' compensation acts.[8]

Through a long line of revenue rulings, the Service has applied the "in the nature of" requirement by examining whether a statute paying disability benefits "provides benefits to a class restricted to employees with service-incurred disabilities." Rev. Rul. 80-14, 1980-1 C.B.

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[7] To prevent the "double" tax benefit of a deduction and an exclusion, section 104(a)(1) does not apply to any amount attributable to a medical expense deduction allowed under Code section 213 for a prior taxable year. Thus, if a Participant has taken such a deduction with respect to an amount payable as a PFRS, SPRS, PERS, or TPAF accidental disability benefit, the amount must be included in the Participant's gross income.

[8] We have assumed that the statutory provisions setting out the PFRS, SPRS, PERS, and TPAF accidental disability benefits could not accurately be characterized as workers' compensation acts.

33. *See also* Rev. Rul. 85-105, 1985-2 C.B. 53; Rev. Rul. 81-47, 1981-1 C.B. 55; Rev. Rul. 80-84, 1980-1 C.B. 35; Rev. Rul. 80-44, 1980-1, C.B. 34; Rev. Rul. 72-291, 1972-1 C.B. 36.[9] Thus, in Revenue Ruling 85-104, the Service held that a District of Columbia statute providing an annuity to a police officer or fire fighter disabled because of an injury or disease incurred other than in the line of duty was not in the nature of a workers' compensation act because it authorized the payment of amounts received as compensation for a "nonoccupational injury or sickness." 1985-2 C.B. 52, 53. For similar reasons, Revenue Ruling 72-44, 1972-1 C.B. 31, held that payments to a fire fighter retired for a disability not incurred in the performance of duties were not excludable under section 104(a)(1). *See also* Rev. Rul. 83-77, 1983-1 C.B. 37 (amounts paid for any disability "whether or not incurred in the line of duty" not excludable under section 104(a)(1)); Rev. Rul. 79-147, 1979-1 C.B. 80 (amounts paid for disability "due to injury received or disease contracted other than in performance of duty" not excludable), *superseded by* Rev. Rul. 85-104, *supra*.

The federal courts have strongly supported this analysis. Two of the leading cases on the question of what constitutes a statute in the nature of a workers' compensation act for purposes of section 104(a)(1) ground the inquiry in the nature of the disability for which benefits are payable under the statute. *See Take v. Commissioner*, 804 F.2d 553 (9th Cir. 1986); *Rutter v. Commissioner*, 760 F.2d 466 (2d Cir.), *cert. denied*, 474 U.S. 848 (1985). In

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[9] Revenue Ruling 83-91, 1983-1 C.B. 38, provides a slightly different standard. The Service there stated that "[d]isability retirement benefits are in the nature of workmen's compensation benefits if they are paid because of an illness stemming from the workmen's employment." *Id.* at 39. However, there is no appreciable analytic difference between this formulation and the one set forth in the Service's other revenue rulings.

Take, an Alaskan fire fighter with heart illness retired under an Anchorage ordinance that, in the view of the court, effectively established "an irrebuttable presumption that heart, lung, and respiratory illnessnes are occupationally related." 804 F.2d at 555. The court stated that statutes "that do not restrict the payment of benefits to cases of work-related injury or illness are not considered to be 'workmen's compensation acts' under section 104." *Id.* at 557. The court noted that the Anchorage ordinance required no "minimum exposure or time-in-job requirements" as a precondition for its presumption and held that "the combination of a loose correlation between basic and presumed facts, along with the absence of any possibility of rebuttal," demonstrated that the ordinance was not in the nature of a workers' compensation act. *Id.* at 558.

Rutter involved a New York City police officer who had received sick leave because of an injury sustained in the line of duty. The sick leave was payable under a collective bargaining agreement providing for compensation during any period of a police officer's illness or injury whether or not connected to the police officer's service. The court held that the sick leave was not excludable under section 104(a)(1) because it was made under a labor contract rather than a statute. Additionally, the court held that, even if the sick leave were considered to be payable under a statute, it was not a statute in the nature of a workers' compensation act because "all sick leave is compensated, whether work related or not." 760 F.2d at 468. Following the Service's analysis that a statute in the nature of a workers' compensation act must restrict the class of disabled employees to whom benefits are payable, the court held that "[u]nless a statute

contains some provision restricting the payment of benefits to cases of work-related disabilities, it is not in the nature of a workmen's compensation statute." *Id.*

The parameters of this test are underscored by the facts in *Rutter*. The police officer there had been "injured in the line of duty," *id.* at 467, but the court found this point "unavailing," *id.* at 468, and refused to apply section 104(a)(1) to his sick leave benefits. The court observed that Treasury Regulations section 1.104-1(b) turns on the "nature of the statute, rather than the source of the injury." *Id.* at 468. Under this "face of the statute" test, the courts examine whether the statute under which benefits are paid distinguishes between occupational and nonoccupational injuries and illnesses rather than whether a particular injury or illness compensated under a disability statute is in fact occupational or nonoccupational. As the Federal Circuit in *Kane v. United States* stated when denying the exclusion of section 104(a)(1) with respect to a disability that both sides agreed was work-related, "it is the *statute*, not the nature of the *injury*, that must be analyzed to determine whether it is in the nature of a workmen's compensation act." 43 F.3d 1446, 1450 (Fed. Cir. 1994) (emphasis in original). *Accord*: *Stanley v. United States*, 140 F.3d 890, 892 (10th Cir. 1998); *Triplett v. United States*, 98-1 USTC ¶ 50,206 (N.D. Cal. 1998); *Craft v. United States*, 879 F. Supp. 925, 931 (S.D. Ind. 1995); *Smelley v. United States*, 806 F. Supp. 932 (N.D. Ala. 1992), *aff'd*, 3 F.3d 389 (11th Cir. 1993); *Green v. Commissioner*, 67 T.C.M. 3074 (1994), *aff'd*, 60 F.3d 142 (2d Cir. 1995); *Givens v. Commissioner*, 90 T.C. 1145 (1988), *nonacq.* 1989-1 C.B. 1; *Haar v. Commissioner*, 78 T.C. 864 (1982), *aff'd*, 709 F.2d 1206 (8th Cir. 1983). *See also Gabriel v.*

Commissioner, 80 T.C.M. 568 (2000) (statute failing to distinguish between occupational and nonoccupational injuries not in nature of workers' compensation act).[10]

Under the standard set out by the Service and the federal courts, the provisions of PFRS, SPRS, PERS, and TPAF providing for accidental disability benefits are statutes in the nature of workers' compensation acts. Those provisions plainly limit benefits to Participants with disabilities incurred in connection with employment. Indeed, each of the four Systems requires that a Participant be disabled as a "direct result of a traumatic event" occurring in connection with the performance of regular or assigned duties. The service-related limitations on these benefits could hardly be drawn more tightly.[11]

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[10] In reaching its result, the *Kane* court noted that a series of earlier cases, examining statutes that provided for both disabilities that were work-related and disabilities that were not, had looked to the source of the taxpayer's disability in determining whether section 104(a)(1) was applicable. 43 F.3d at 1450 (*citing Simms v. Commissioner*, 196 F.2d 238 (D.C. Cir. 1952), *Neill v. Commissioner*, 17 T.C. 1015 (1051), and *Frye v. United States*, 72 F. Supp. 405 (D.D.C. 1947)). The *Kane* court distinguished those cases on the ground that the statutes at issue there involved "at least one provision" specifically providing for work-related disabilities. *Id.* The court might also have noted that all those cases predated Treasury Regulations section 1.104-1(b) and, therefore, were decided before the issuance of specific administrative guidance for determining whether a statute is in the nature of a workers' compensation act.

[11] A few authorities have suggested different standards for determining whether a statute is in the nature of a workers' compensation act, but they do not produce a contrary conclusion for the PFRS, SPRS, PERS, and TPAF accidental disability benefits. *Waller v. United States*, 180 F.2d 194, 196 (D.C. Cir. 1950), generally noted the character of workers' compensation acts as having "a purpose of fixing and making certain the payment of some compensation for injury, free of the risks of litigation based on negligence" where the "amount of compensation depends upon the nature of the injury, which is translated into the degree of loss of earning power." However, the *Waller* analysis – which suggests that the benefit amounts should correlate to the degree of injury – has not been followed by the Service or the courts and, in any event, predates Treasury Regulations section 1.104-1(b). *Duncan v. United States*, 96-2 USTC ¶ 50,685 (E.D. Ky. 1996), *acq. in part* 1997-1 C.B. 1, and *Craft v. United States*, 879 F. Supp. 925 (S.D. Ind. 1995), suggest that whether a statute is in the nature of a workers' compensation act depends on three factors: whether the statute requires a work-related injury; whether the statute is the employee's exclusive remedy against the employer; and whether the payments under the statute vary according to the degree of disability. Again, these decisions are not supported by the Service's established position or by appellate case law, and they do not control here. Other authorities try to explain the theory of workers' compensation without narrowing the test developed by the Service and the courts for whether a statute is in the nature of a workers' compensation act. *See, e.g.*, Gen. Coun. Mem. 37771 (Nov. 30, 1978) (workers' compensation provides compensation for work-related injuries or illness, relieves employees of contributory-negligence defenses, and

The fact that the Systems generally are maintained to provide retirement benefits to Participants does not affect this result. The Service and the courts have consistently applied the section 104(a)(1) exclusion to accidental disability benefits set out in statutory schemes providing accidental disability benefits side-by-side with ordinary disability benefits or retirement benefits. Thus, in Revenue Ruling 83-91, 1983-1 C.B. 38, the Service held section 104(a)(1) applicable to an accidental disability benefit provided under the Maryland State Teachers' Retirement System. Similarly, Revenue Ruling 72-45, 1972-1 C.B. 32, confirmed the excludability of accidental disability "pensions" set forth in a section of the Code of the City of New York providing for both disability and service-based retirement. *See also* Gen. Coun. Mem. 39382 (July 16, 1985) (referring to "well settled" position of Service that employer may exclude accidental disability benefits even if "same benefits . . . [are] obtainable under . . . normal retirement provisions"). And *Picard v. Commissioner*, 165 F.3d 744 (9th Cir. 1999), held that accidental disability benefits were excludable even where provided under a city charter governing the general retirement of police officers. *See also Triplett v. United States*, 98-1 USTC ¶ 50,206 (N.D. Cal. 1998) (sick pay provided by California Public Employees Retirement System excludable under section 104(a)(1)); *Frye v. United States*, 72 F. Supp. 405 (D.D.C. 1947) (accidental disability benefits under single statute providing for retirement by reason of work-related disability, years or service, or age held excludable).

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provides remedies without resorting to lawsuits); Rev. Rul. 73-346, 1973-2 C.B. 24 (payments under statute in nature of workers' compensation act cannot be voluntary).

The nature of the general statutory scheme under which accidental disability benefits are payable simply does not control whether the accidental disability benefits themselves are provided under a workers' compensation act or a statute in the nature of a workers' compensation act. Rev. Rul. 72-191, 1972-1 C.B. 45 (nonoccupational disability benefits not excludable under section 104(a)(1) even though provided under state workers' compensation act). The relevant inquiry is not whether PFRS, SPRS, PERS, and TPAF are, broadly conceived, intended to be retirement plans or accidental disability plans; rather, the relevant inquiry is whether the particular provisions that set out the PFRS, SPRS, PERS, and TPAF accidental disability benefits limit those benefits to Participants with service-related disabilities. The broader scope of the four Systems does not frustrate the application of section 104(a)(1) to the narrowly drawn accidental disability benefits that they provide.[12]

Similarly, the fact that amounts paid to a Participant as an accidental disability benefit under any of the four Systems are reduced by the amount that the Participant receives under New Jersey workers' compensation acts does not imply that the statutes providing the accidental disability benefits are not in the nature of workers' compensation acts. In Revenue Ruling 83-91, *supra*, the Service specifically ruled that an accidental disability retirement benefit under the Maryland State Teachers' Retirement System was made under a statute in the nature of a workers' compensation act even though the accidental disability benefit offset amounts payable under Maryland's workers' compensation act. Indeed, the offset under New Jersey law only

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[12] Also, it should be noted that both PFRS and SPRS are intended to provide "retirement allowances and *other benefits* . . . ." N.J.S.A. 43:16A-2 and 53:5A-4 (emphasis added). Thus, even the broad statements of the Systems' purpose is not limited to retirement benefits.

underscores the fact that the accidental disability benefits are made under statutes in the nature of workers' compensation acts: the coordination of the two sets of benefits is appropriate precisely because the accidental disability benefits under the Systems are intended to parallel and to supplement actual workers' compensation benefits.

Finally, the fact that the Systems in certain cases may pay accidental disability benefits on the basis of applications filed several years after the event that causes the disability does not imply that the underlying PFRS, SPRS, PERS, and TPAF statutes are not in the nature of workers' compensation acts. In *Stanley v. United States*, 140 F.2d 890 (10th Cir. 1998), the government challenged the excludability of certain payments made to retired police officers and fire fighters, in part because they had not applied for disability benefits until between six and 24 years after their injuries. However, the *Stanley* court reversed the lower court's grant of summary judgment for the government and held that "the lengthy interval between the officers' and firefighters' initial injuries and their filing for benefits is not fatal to the determination that [the statutes] are . . . in the nature of workmen's compensation acts." *Id.* at 893. Instead, the court held, the time interval was more appropriately considered a factor in whether the payments were received under a statute in the nature of workers' compensation as compensation for injury or illness. *Id.* Whatever the implications of *Stanley* may be for other cases, here it is clear that any Participant applying for PFRS, SPRS, PERS, or TPAF accidental disability benefits more than five years after the Participant's injury must demonstrate a causal connection between the disability and the injury. Thus, the relaxation of the application period under these statutes does not relax the requirement that the disability be work-related.

2. *Basis for Determination of Benefit Amounts*

The PFRS, SPRS, PERS, and TPAF accidental disability benefits also satisfy the second element for excludability under section 104(a)(1) because those benefits are not retirement pensions or annuities determined by reference to a Participant's age, length of service, or past contributions. Although there are slight differences among them, the accidental disability benefits under the Systems generally comprise an annuity attributable to the Participant's own contributions and a pension that, when added to the annuity, yields a benefit stream equal to two-thirds of the Participant's compensation. Thus, the benefits plainly are not determined by reference to a Participant's age or length of service. Additionally, although the calculation of the benefit amount nominally refers to a Participant's contributions to the System, close analysis reveals that, except in very limited circumstances, those contributions do not actually affect the benefit amount payable to a Participant.

Distinguishing between statutes providing for service retirements and statutes providing for accidental disability retirements has commanded almost as much attention from the Service and the courts as has distinguishing between statutes providing for ordinary disabilities and statutes providing for accidental disabilities. Statutes referring to age as a basis for benefit payments are readily identifiable: they ordinarily use an employee's age as the trigger for converting a stream of benefits from accidental disability benefits to ordinary service retirement benefits or simply as the basis for ordinary service retirement. Thus, for example, in Revenue Ruling 80-14, *supra*, a city statute provided disabled employees accidental disability benefits

until the age of 62, at which time it provided them normal retirement pensions based on years of service. The Service held that the accidental disability benefits were excludable only through the age of 62. And in *Simms v. Commissioner*, 196 F.2d 238 (D.C. Cir. 1952), the District of Columbia Circuit held that a fire fighter had been retired under a statutory rule providing for retirement at age 60. Although it appears that the fire fighter could have been retired for disability, the court determined that his retirement for age denied him the exclusion under the statutory predecessor of section 104(a)(1).

Statutes referring to length of service ordinarily use the employee's number of years of service as a multiplier in determining the benefit amount payable or as the basis for converting an employee to ordinary service retirement. Revenue Ruling 80-44, *supra*, considered city statutes under which a "service-connected disability retirement allowance [was] an amount equal to the greater of (A) 60 percent of the individual's final average compensation, or (B) the amount to which the individual would be entitled under the ordinary, nonoccupational disability pension provisions of [the city's] statutes (a pension based on years of service)." The Service ruled that the allowance was excludable to the extent of 60 percent of an individual's final average compensation but that the excess over that amount was "attributable to the length of service" and so was not excludable under section 104(a)(1). *Id.* at 35. *See also* Rev. Rul. 85-105, *supra*; 85-104, *supra*; Rev. Rul. 72-44, *supra*. *Wiedmaier v. Commissioner*, 774 F.2d 109 (6th Cir. 1985), held that a disabled fire fighter lost the benefit of the section 104(a)(1) exclusion when his accidental disability benefit was converted to ordinary retirement after he reached the point at which he would have had 25 years of service had he not become disabled.

See also Benjamin v. Commissioner, 66 T.C.M. 1488 (1993) (no exclusion where statute uses number of years of service as multiplier in determining benefit); *Mabry v. Commissioner*, 50 T.C.M. 336, 337 (1985) ("[W]e and other courts have consistently held that, in order to be excludable under section 104(a)(1), retirement pensions or payments may not be based on any factor other than disability and, where payments are based upon any other factor, such as age or length of service on the job, the retirement plan in question will not qualify as similar to workmen's compensation acts within the meaning of section 104.").

The statutes providing PFRS, SPRS, PERS, and TPAF accidental disability benefits do not refer to length of service as a determinant in the amount payable to Participants. The only references to age are the provisions in PERS and TPAF limiting eligibility for accidental disability benefits to Participants who have not reached the age of 65. However, the amount of the accidental disability benefits under PERS and TPAF are not determined on the basis of Participants' ages; age operates only to restrict the class of Participants to whom benefits are payable.

Additionally, the fact that the accidental disability benefits are calculated as a fraction of a Participant's compensation does not cause the underlying New Jersey statutes not to be in the nature of workers' compensation acts. The Service has maintained this position at least since Revenue Ruling 68-10, 1968-1 C.B. 50. There, the Service considered a provision of the California Labor Code that provided certain law enforcement officers with continuation of full salary during a leave of absence for accidental disability of no more than one year. The Service reasoned as follows: "The payments made under [the relevant provision] of the California

Labor Code are made because of injuries or illness arising out of and in the course of the employee's duties. The fact that the amount received is equal to the employee's salary does not prevent such payments from being compensation within the meaning of workmen's compensation." *Id.* at 51. *See also* Rev. Rul. 85-104, *supra*, at 53 ("The fact that the amount received is equal to the employee's salary at the date of disability or is based on a percentage of that salary does not disqualify the payment from qualifying as one in the nature of workmen's compensation."); *Rev.* Rul. 80-14, *supra* (accidental disability benefits equal to 75 percent of employee's salary at time of injury); Rev. Rul. 72-136, 1972-1 C.B. 35 (accidental disability benefits equal to full salary), *superseded by* Rev. Rul. 75-500, 1975-2 C.B. 44. Indeed, when the Service attempted to assert a contrary position in *Dyer v. Commissioner*, 71 T.C. 560 (1979), *acq.* 1987-1 C.B. 1 and 1987-2 C.B. 1, the Tax Court reaffirmed that "whether a payment is in the nature of workmen's compensation depends upon whether the payment is made because of injuries sustained in the line of duty, not upon the amount paid." *Id.* at 562. Because an accidental disability payment of full compensation is excludable under section 104(a)(1), *a fortiori* an accidental disability payment under the Systems of two-thirds of compensation is excludable as well.[13]

Finally, the fact that the PFRS, SPRS, PERS, and TPAF accidental disability benefits incorporate reference to a Participant's own contributions to the System generally does not

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[13] Obviously, benefits determined as a fraction of the employee's compensation generally will be larger for older employees and employees with longer periods of service. This indirect link between age or years of service and benefit amounts has not led the Service to determine that benefits based on compensation fail to be in the nature of workers' compensation for purposes of section 104(a)(1).

make section 104(a)(1) inapplicable. As indicated above, those benefits have two components: an annuity that is actuarially equivalent to the Participant's contributions to the System and a pension that, when added to the annuity, provides a total benefit of two-thirds of the Participant's compensation. A preliminary reading of these provisions suggests that the accidental disability benefits are determined in part on the basis of Participant contributions. But a closer analysis reveals that the Participant's contributions ordinarily do *not* affect the benefit amount payable to the Participant.

Assuming the annuity that is the actuarial equivalent of the Participant's contributions itself does not exceed two-thirds of the Participant's compensation, the total accidental disability benefit payable to a Participant will be no greater than and no less than two-thirds of the Participant's compensation – regardless of how much the Participant has contributed to the System. In other words, the amount of the Participant's contributions to the System generally does not alter the calculation of the Participant's accidental disability benefit, and the benefit is therefore not dependent on the amount of a Participant's past contributions to the System. For this reason, the reference to the Participant's own contributions does not limit the excludability of the accidental disability benefits except for any portion of the annuity provided by those contributions that exceeds two-thirds of the Participant's compensation. *See* Rev. Rul. 85-104, *supra*, at 53 ("the fact that employees contribute a percentage of their salary to a retirement fund" paying accidental disability benefits does not make section 104(a)(1) inapplicable if "the amount of the disability pensions does not depend on the amount so contributed"). Indeed, the Service has reached precisely this conclusion in the many cases where it has been asked to

determine the excludability of PFRS accidental disability benefits. *See, e.g.*, Priv. Ltr. Rul. 200016012 (Jan. 21, 2000); Priv. Ltr. Rul. 199903039 (Oct. 7, 1999); Priv. Ltr. Rul. 9740020 (July 2, 1997); Priv. Ltr. Rul. 9716008 (Jan. 13, 1997); Priv. Ltr. Rul. 9647016 (Aug. 21, 1996); Priv. Ltr. Rul. 9639058 (June 25, 1996); Priv. Ltr. Rul. 9633024 (May 16, 1996); Priv. Ltr. Rul. 9625009 (Mar. 18, 1996); Priv. Ltr. Rul. 9624017 (Mar. 15, 1996); Priv. Ltr. Rul. 9619030 (Feb. 2, 1996); Priv. Ltr. Rul. 9416030 (Jan. 19, 1994); Priv. Ltr. Rul. 9245037 (Aug. 12, 1992); Priv. Ltr. Rul. 8925057 (Mar. 28, 1989); Priv. Ltr. Rul. 8924055 (Mar. 21, 1989).

3. *Limitation on Benefit Amount*

The third and final element for excludability under section 104(a)(1) is perhaps the most deceptive. This element requires that the accidental disability benefits not exceed the amount provided under the applicable workers' compensation act. As formulated in Treasury Regulations section 1.104-1(b), this element might appear to deny the excludability of any PFRS, SPRS, PERS, or TPAF accidental disability benefits in excess of amounts payable under New Jersey workers' compensation laws. However, neither the Service or the courts have construed this element in that manner.

For almost 25 years, the Service maintained the position that this third element simply does not apply to accidental disability benefits payable under a statute in the nature of workers' compensation acts (as opposed to the workers' compensation acts themselves). Thus, in Revenue Ruling 59-269, 1959-2 C.B. 39, the Service ruled that accidental disability benefits payable under Hawaii law were excludable in full even though payment of those benefits fully

offset any lesser amounts payable under the Hawaii workers' compensation acts. In so holding, the Service explained the administrative origin of the rule set out in the regulations limiting the exclusion to amounts payable under workers' compensation acts:

> The provision in section 1.104-1(b) of the regulations, to the effect that the exclusion does not apply 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 or acts, is a reiteration of the rule laid down in Revenue Ruling 103, C.B. 1953-1, 20. It was there held that payments in excess of workmen's compensation under a differential payment plan, which was not in itself a plan of accident or health insurance within the purview of section 22(b)(5) of the 1939 Code and which was not paid pursuant to a court-sanctioned agreement which, according to state statute, was in lieu of workmen's compensation, are includible in the employee's gross income unless it can be shown that the payments were made under an agreement in satisfaction of a tort or tort-type liability other than a liability under a workmen's compensation act. *The limitation therefore does not apply to statutes in the nature of workmen's compensation which give recovery in lieu of or supplemental to workmen's compensation which may be in excess of that received under the ordinary workmen's compensation act.*

Id. at 41 (emphasis added). In other words, the rule in Treasury Regulations section 1.104-1(b) regarding amounts in excess of workers' compensation benefits was intended to provide for the inclusion of amounts paid by an employer under a plan intended to supplement workers' compensation; it was not intended as a limitation on the excludability of amounts paid under a statute in the nature of a workers' compensation act. Thus, the Service simply concluded that the third element has no application where the exclusion is sought under a statute in the nature of a workers' compensation act rather than under a workers' compensation act. The Service reiterated this position in Revenue Ruling 68-10, *supra*, and Revenue Ruling 72-45, *supra*, and

the Tax Court enforced it in *Dyer*, 71 T.C. at 563 n.4.[14] *See also* Gen. Coun. Mem. 39002 (June 17, 1983) ("The Service's position has always been that if the disability payments are made pursuant to a statute in the nature of a workmen's compensation act, those payments are not subject to the regulatory limitation which provides that the exclusion is disallowed to the extent that the amounts received are in excess of the amounts receivable under the applicable workmen's compensation act.").

In Revenue Ruling 83-91, *supra*, the Service slightly modified its position on this point. There, the Service considered whether a Maryland school teacher entitled to receive either workers' compensation or a larger disability retirement allowance under a Maryland statute in the nature of a workers' compensation act was permitted to exclude the entire disability retirement allowance. In ruling for exclusion of the full amount of the disability retirement allowance – including the portion in excess of Maryland workers' compensation – the Service determined that the third element of section 104(a)(1) *does* apply to a statute in the nature of a workers' compensation act. The Service held, however, that the third element operates only to limit the exclusion to amounts provided under that statute rather than to limit the exclusion to amounts provided under the workers' compensation act: "The limitation in the regulation merely denies exclusion under section 104(a)(1) to the extent that amounts received are in excess of the amount provided by the regular workmen's compensation act or by a statute in the nature of a workmen's compensation act, *whichever is the basis for exclusion in the particular case*. It does not apply to limit the exclusion of payments made under a statute in the nature of

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[14] As noted above, the Service has acquiesced in *Dyer*. *See* 1987-1 C.B. 1 and 1987-2 C.B. 1.

a workmen's compensation act to the amount allowable under the state's general workmen's compensation statute." *Id.* at 38 (emphasis added). Thus, the Service looked only to the Maryland statute in the nature of a workers' compensation act to determine the outer bound on the excludable accidental disability benefits.[15]

Application of the third element to the PFRS, SPRS, PERS, and TPAF accidental disability benefits is therefore trivial. For those benefits, the third element simply limits the exclusion to the amounts payable under the Systems as accidental disability benefits. The fact that those benefits exceed amounts payable under New Jersey workers' compensation law has no consequence.

CONCLUSION

In summary, we think the accidental disability benefits provided to Participants under New Jersey Statutes Annotated sections 43:16A-7 (PFRS), 53:5A-10 (SPRS), 43:15A-43 and -46 (PERS), and 18A:66-39.c and -42 (TPAF) should be excludable from gross income under Code section 104(a)(1) (except as otherwise indicated above with respect to amounts attributable to a Participant's prior medical expense deduction under Code section 213 and amounts in excess of two-thirds of a Participant's prior compensation). In our opinion it is substantially more likely than not that this position would prevail if the question were litigated on the merits.

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[15] Although it is not binding on the Service as precedent, Field Service Advice 200024018 (June 16, 2000) recently reiterated this long-standing position.

This opinion is intended only for the party to whom it is addressed and may not be used or relied upon by any other party for any purpose.

Sincerely,

Caplin & Drysdale, Chartered

CAPLIN & DRYSDALE, CHARTERED