

Taxation of Duty-Related Disability Benefits

Issue:

The statutory structure of disability benefits for LEOFF Plan 2 does not allow members who become disabled in the line of duty to take advantage of federal law which makes those benefits wholly, or partially, nontaxable.

A. Background:

Withdrawals:

A LEOFF 2 member may request a refund of their accumulated contributions and interest any time after they separate from employment, regardless of the reason for the separation. A LEOFF 2 member with ten or more years of service is entitled to withdraw 150% of their accumulated account balance. The member's account balance includes member contributions and interest credited at the rate of 5.5% annually, compounded quarterly, as determined by the Director of the Department of Retirement Systems. The member's account balance does not include state or employer contributions.

Disability Retirement:

A LEOFF 2 member who becomes totally incapacitated for continued LEOFF employment is eligible to receive a disability retirement benefit. The amount of the benefit is equal to 2% of the member's final average salary for each year of service actuarially reduced to reflect the difference between the member's age at the time of disablement and the normal retirement age of 53. A member may elect to withdraw their accumulated contributions in lieu of receiving a disability retirement.

Experience:

There have been very few disability retirements since the inception of LEOFF Plan 2 in October 1977. Approximately 250 LEOFF 2 members a year withdraw their accumulated contributions. The number of members who withdraw their accumulated contributions following separation from employment due to a duty-related disability is not known.

B. Taxation of Duty Disability Benefits:

IRS Requirements for Nontaxability:

A service-connected disability benefit under a "statute in the nature of a workmen's compensation act" is nontaxable under Internal Revenue Code section 104(a)(1).

- The benefits can be provided under a retirement plan in addition to worker's compensation benefits. [Rev. Rul. 68-10, 1968-1 C.B. 50; Private Letter Ruling 9801007 (September 24, 1998)]

- In order to qualify, the benefits must apply only to service-connected disabilities. However, if the benefits are provided under different provisions of statute, even if the benefits are identical, benefits provided under the service-connected disability provision will qualify. [Rev. Rul. 85-104, 1985-2 C.B. 52; Rev. Rul. 74-582, 1974-2 C.B. 34]
- In order to qualify, the benefit cannot be based on employee contributions. However, member contributions to LEOFF 2 are subject to “pick-up” by employers and are not treated as employee contributions by the IRS. [Treas. Reg. 1.104-1]
- In order to qualify, the disability benefit must not be based on years of service or age. [Rev. Rul. 85-104, 1985-2 C.B. 52] Eligibility for the 150% withdrawal is currently limited to members who have ten years of service.
- If a service-connected disability provision provides a benefit based on age and/or years of service, subject to minimum which is not based on years of service, the benefit will be broken into two parts:
 1. Only the minimum benefit can qualify as a service-connected disability benefit [Rev. Rul. 85-104, 1985-2 C.B. 52]
 2. The remainder of the disability benefit is subject to the provisions for a non-service connected disability benefit.

Analysis of current LEOFF 2 benefits:

The LEOFF 2 disability retirement benefit is entirely based on both years of service and age so it is taxable under federal law. Every vested member is entitled to at least 10% of average final salary (5 years of service multiplied by 2% per year multiplied by average final salary). If a minimum duty-disability benefit for vested members of 10% of average final salary were established, that minimum benefit would meet the federal requirements to be considered nontaxable.

The LEOFF 2 150% withdrawal benefit would meet the federal requirements to be considered nontaxable if the ten-year service requirement were eliminated for members who separate from service due to a duty-related disability.

Retroactivity:

A person may amend their federal income tax return up to three years after filing. A retroactive statutory change could allow a LEOFF 2 member who withdrew their contributions following a duty-related disability in the past three years to re-file their tax return with a reduced taxable income and potentially receive a federal income tax refund.

RCW 41.26.470

Earned disability allowance -- Cancellation of allowance -- Reentry -- Receipt of service credit while disabled -- Conditions -- Disposition upon death of recipient.

(1) A member of the retirement system who becomes totally incapacitated for continued employment by an employer as determined by the director shall be eligible to receive an allowance under the provisions of RCW [41.26.410](#) through [41.26.550](#). Such member shall receive a monthly disability allowance computed as provided for in RCW [41.26.420](#) and shall have such allowance actuarially reduced to reflect the difference in the number of years between age at disability and the attainment of age fifty-three.

(2) Any member who receives an allowance under the provisions of this section shall be subject to such comprehensive medical examinations as required by the department. If such medical examinations reveal that such a member has recovered from the incapacitating disability and the member is no longer entitled to benefits under Title [51](#) RCW, the retirement allowance shall be canceled and the member shall be restored to duty in the same civil service rank, if any, held by the member at the time of retirement or, if unable to perform the duties of the rank, then, at the member's request, in such other like or lesser rank as may be or become open and available, the duties of which the member is then able to perform. In no event shall a member previously drawing a disability allowance be returned or be restored to duty at a salary or rate of pay less than the current salary attached to the rank or position held by the member at the date of the retirement for disability. If the department determines that the member is able to return to service, the member is entitled to notice and a hearing. Both the notice and the hearing shall comply with the requirements of chapter [34.05](#) RCW, the Administrative Procedure Act.

(3) Those members subject to this chapter who became disabled in the line of duty on or after July 23, 1989, and who receive benefits under RCW [41.04.500](#) through [41.04.530](#) or similar benefits under RCW [41.04.535](#) shall receive or continue to receive service credit subject to the following:

(a) No member may receive more than one month's service credit in a calendar month.

(b) No service credit under this section may be allowed after a member separates or is separated without leave of absence.

(c) Employer contributions shall be paid by the employer at the rate in effect for the period of the service credited.

(d) Employee contributions shall be collected by the employer and paid to the department at the rate in effect for the period of service credited.

(e) State contributions shall be as provided in RCW [41.45.060](#) and [41.45.067](#).

(f) Contributions shall be based on the regular compensation which the member would have received had the disability not occurred.

(g) The service and compensation credit under this section shall be granted for a period not to exceed six consecutive months.

(h) Should the legislature revoke the service credit authorized under this section or repeal this section, no affected employee is entitled to receive the credit as a matter of contractual right.

(4)(a) If the recipient of a monthly retirement allowance under this section dies before the total of the retirement allowance paid to the recipient equals the amount of the accumulated contributions at the date of retirement, then the balance shall be paid to the member's estate, or such person or persons, trust, or organization as the recipient has nominated by written designation duly executed and filed with the director, or, if there is no such designated person or persons still living at the time of the recipient's death, then to the surviving spouse, or, if there is neither such designated person or persons still living at the time of his or her death nor a surviving spouse, then to his or her legal representative.

(b) If a recipient of a monthly retirement allowance under this section died before April 27, 1989, and before the total of the retirement allowance paid to the recipient equaled the amount of his or her accumulated contributions at the date of retirement, then the department shall pay the balance of the accumulated contributions to the member's surviving spouse or, if there is no surviving spouse, then in equal shares to the member's children. If there is no surviving spouse or children, the department shall retain the contributions.

(5) Should the disability retirement allowance of any disability beneficiary be canceled for any cause other than reentrance into service or retirement for service, he or she shall be paid the excess, if any, of the accumulated contributions at the time of retirement over all payments made on his or her behalf under this chapter.

(6) A member who becomes disabled in the line of duty, and who ceases to be an employee of an employer except by service or disability retirement, may request a refund of one hundred fifty percent of the member's accumulated contributions. Any accumulated contributions attributable to restorations made under RCW 41.50.165(2) shall be refunded at one hundred percent.

(7) A member who becomes disabled in the line of duty shall be entitled to receive a minimum retirement allowance equal to ten percent of such member's final average salary. Such member shall additionally receive a retirement allowance equal to two percent of such member's average final salary for each year of service beyond five, and shall have such allowance actuarially reduced to reflect the difference in the number of years between age at disability and the attainment of age fifty-three. Such additional benefit shall not result in a total monthly benefit greater than that provided in (1).

LEOFF 2

Duty-related Disability

Duty disability benefits in LEOFF 2 are distinct from those in plan 1 in that they are an earned retirement benefit rather than a fixed percent of pay regardless of time in service.

LEOFF 2 members who meet the various duty disability standards are eligible for an earned retirement benefit, worker's compensation benefits, possibly Social Security benefits, and supplemental disability insurance coverage if enrolled. If there is a question of employer liability in a disability case, members also have the right to bring legal action against their employer.

This paper will provide an overview of the various disability standards and benefits.

LEOFF 2 Duty Disability Standard (RCW 41.26.470)

A member who becomes totally incapacitated for continued employment by an employer as determined by the director shall be eligible to receive an allowance under the provisions of RCW 41.26. Such member shall receive a monthly disability allowance computed as provided for in RCW 41.26.420 and shall have such allowance actuarially reduced to reflect the difference in the number of years between age at disability and the attainment of age fifty-three.

Early Hire LEOFF 2 Disability Scenario

43 years of age, 20 years of service, \$70,000 salary
Actuarial reduction factor for a member 10 years from retirement age: .3921
Benefit: $\$68,068 \times 20 \times 2\% \times .3921 = \$10,676$ per year or \$890 per month

Average LEOFF 2 Member Disability Scenario

38 years of age, 10 years of service, \$59,600 salary
Actuarial reduction factor for a member 15 years from retirement age: .2541
Benefit: $\$57,287 \times 10 \times 2\% \times .2541 = \$2,911$ per year or \$243 per month

Disability Leave Supplement for a Temporary Total Disability (RCW 41.04.500)

Employers of LEOFF members shall provide a disability leave supplement to employees who qualify for payments under the Department of Labor and Industries Worker's Compensation program (RCW 51.32.090) due to a temporary total disability.

Disability Leave Supplement Amount (RCW 41.04.505)

The disability leave supplement shall be an amount which, when added to the amount payable under RCW 51.32.090 will result in the employee receiving the same pay they would have received for full time active service, taking into account that industrial insurance payments are not subject to federal income or social security taxes.

This benefit is paid for through use of employee's sick and annual leave accumulations and employer payments: ½ employee; ½ employer.

Disability Leave Supplement Estimates		
	Early Hire LEOFF 2	Average LEOFF 2
Monthly Salary	\$5,833	\$4,967
L&I Tax-free equivalent ¹	\$4,380	\$4,380
Supplement amount	\$1,453	\$587

¹Assumes a 15% tax rate.

Employer Liability

Beyond these benefits LEOFF 2 members are eligible to receive, they also have the right to sue their employer if their disability is a result of negligence on the part of their employer (RCW 41.26.280 and RCW 41.26.281)

Other Issues

Because LEOFF 1 members are not eligible for Worker's Compensation, and because their duty-disability retirement benefit is awarded in the nature of worker's compensation, it is tax free. In comparison, LEOFF 2 members are eligible for worker's compensation, and their duty-disability retirement benefit is an earned retirement benefit. As a result, their duty-disability retirement benefit is not tax free.

Lump-Sum Alternative

At this time there are no LEOFF 2 members receiving a duty-disability retirement benefit. Because of the age and service characteristics of LEOFF 2 members who have been disabled, the actuarial reduction results in a modest duty disability retirement allowance. Up to this date, all members have opted for a refund of 150% of their accumulated contributions and interest in lieu of a duty disability retirement benefit.

The duty-disabled 43 year old with 20 years of service and \$70,000 salary would be eligible to withdraw \$230,000.

The duty-disabled 38 year old with 10 years of service and \$59,600 salary would be eligible to withdraw \$71,000.

Worker's Compensation:

Time-Loss Benefits

Those unable to work as a result of injury or disease, will be paid a portion of their regular wages. These time-loss compensation payments will not provide the same income as when they were working (this is where the disability leave supplement applies.)

The amount of a time-loss benefit is 60 to 75 percent of a worker's gross income (includes wages/salary plus medical, dental, and vision benefits, room and board, bonuses, and tips). The percentage depends on the worker's marital status and number of dependents. These benefits cannot exceed 120 percent of the state's average wage ($\$37,229 \times 1.2 = \$44,675$).

Awards for Partial Permanent Disabilities

If an injury or occupational disease causes permanent loss of bodily function, the injured worker will receive a permanent partial disability award. The amount received for any physical loss is established by the Legislature and does not include compensation for pain and suffering. There are two types of permanent partial disabilities:

- Specified disabilities: Some disabilities have awards that are already set by law. These are easily quantified losses, such as loss of your vision or hearing, or the loss of an eye, leg, foot, toe, arm or finger by amputation (see Appendix A.)
- Unspecified disabilities: These disabilities include every other type of impairment caused by an on-the-job injury or occupational illness, including the partial loss of function to a limb.

Rating Unspecified Disabilities

The degree of a partial loss of function is determined by a disability rating. These ratings are conducted either by the attending physician, or by one or more independent medical examiners using established medical standards and guidelines. Normally, ratings are performed after all services have been completed, the injured worker is medically stable and no further treatment is appropriate.

A permanent partial disability award is not jeopardized by working. Workers are encouraged to return to their job as soon as their doctor releases them for work. Any permanent partial disability award is based on the degree of damage suffered, not on whether you can work.

Pensions for Total Permanent Disabilities

If an accident results in the loss or total paralysis of both legs or arms, one leg and one arm, or a total loss of eyesight, a worker is eligible for a pension by law, even if able to return to work.

If vocational and medical evaluations determine that an injury prevents a worker from ever becoming gainfully employed, they may be paid a monthly pension for life. However, this type of "non-statutory" pension may not be payable if a worker is able to return to work.

Pension benefits are paid monthly. They are based on the amount of time-loss compensation to which a worker is entitled. As with time-loss compensation benefits, the amount a worker is eligible to receive depends on factors such as wages, marital status, number of dependents, health care benefits, Social Security benefits and the state's average wage at the time of your injury. In some cases, a pension benefit amount may be reduced for previously paid permanent partial disability awards.

Pension Survivor Options

If a worker is granted an L&I pension, they can choose one of these survivor options:

- An unreduced single life pension.
- A reduced joint and 50% pension.
- A further reduced joint and 100% pension.

Social Security Disability:

The definition of disability under Social Security is different than other programs. Social Security pays only for total disability. No benefits are payable for partial disability or for short-term disability.

Disability under Social Security is based on an individual's inability to work. An individual is considered disabled under Social Security rules if they cannot do work they did before and they cannot adjust to other work because of their medical condition(s). An individual's disability must also last or be expected to last for at least one year or to result in death.

This is a strict definition of disability. Social Security program rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including workers' compensation, insurance, savings and investments.

Social Security Standard for Disability

Those applying for a Social Security disability benefit are evaluated via a progressive series of question beginning with...

... **Are they working?** Those currently working and earning more than \$780 a month generally are not disabled. For those not working...

... **Is their condition "severe"?** A condition must interfere with basic work-related activities to be a disability. If it does not, there is no disability. If it does...

... **Is their condition on the list of disabling conditions?** Social Security maintains a list of medical conditions that automatically mean a worker is disabled. If the condition is not on the list, Social Security determines if it is of equal severity to a condition on the list. If it is, the worker is disabled. If it is not...

... **Can they do the work they did previously?** If the condition is severe but not at the same or equal level of severity as a medical condition on the list, then Social Security determines if it interferes with their ability to do the work they did previously. If it doesn't, the claim will be denied. If it does...

... **Can they do any other type of work?** If they cannot adjust to other work, their claim will be approved. If they can adjust to other work, their claim will be denied.

Estimated Social Security Disability Award	
Early Hire LEOFF 2	\$1,629 / month
LEOFF 2 Average	\$1,550 / month

How Much Work Is Needed?

In addition to meeting the Social Security definition of disability, a worker must have worked long enough--and recently enough--under Social Security to qualify for disability benefits. Social Security work credits are based on total yearly wages or self-employment income. Up to four credits can be earned each year. The amount needed for a credit changes from year to year. For 2002, \$870 of wages will earn one credit, and \$3,480 of wages will earn the maximum four credits.

The number of work credits needed to qualify for disability benefits depends on the age of disability. Generally, a workers needs 40 credits, 20 of which were earned in the last 10 years ending with the year they become disabled. However, younger workers may qualify with fewer credits.

Appendix A

L&I AWARDS FOR LOSS BY AMPUTATION

July 1, 2002

Of leg above the knee joint with short thigh stump (3" or less below the tuberosity of ischium)	\$94,793
Of leg at or above knee joint with functional stump	\$85,313
Of leg below knee joint	\$75,834
Of leg at ankle (Syme)	\$66,355
Of foot at mid-metatarsals	\$33,177
Of great toe with resection of metatarsal bone	\$19,906
Of great toe at metatarsophalangeal joint	\$11,944
Of great toe at interphalangeal joint	\$6,320
Of lesser toe (2nd to 5th) with resection of metatarsal bone	\$7,267
Of lesser toe at metatarsophalangeal joint	\$3,539
Of lesser toe at proximal interphalangeal joint	\$2,623
Of lesser toe at distal interphalangeal joint	\$664
Of arm at or above the deltoid insertion or by disarticulation at the shoulder	\$94,793
Of arm at any point from below the deltoid insertion to below the elbow joint at the insertion of the biceps tendon	\$90,053
Of arm at any point from below the elbow joint distal to the insertion of the biceps tendon to and including mid-metacarpal amputation of the hand	\$85,313
Of all fingers except the thumb at metacarpophalangeal joints	\$51,188
Of thumb at metacarpophalangeal joint or with resection of carpometacarpal bone	\$34,125
Of thumb at interphalangeal joint	\$17,063
Of index finger at metacarpophalangeal joint or with resection of metacarpal bone	\$21,328
Of index finger at proximal interphalangeal joint	\$17,063
Of index finger at distal interphalangeal joint	\$9,384
Of middle finger at metacarpophalangeal joint or with resection of metacarpal bone	\$17,063
Of middle finger at proximal interphalangeal joint	\$13,650
Of middle finger at distal interphalangeal joint	\$7,678
Of ring finger at metacarpophalangeal joint or with resection of metacarpal bone	\$8,531
Of ring finger at proximal interphalangeal joint	\$6,825
Of ring finger at distal interphalangeal joint	\$4,266
Of little finger at metacarpophalangeal joint or with resection of metacarpal bone	\$4,266
Of little finger at proximal interphalangeal joint	\$3,413
Of little finger at distal interphalangeal joint	\$1,706