

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Roger P. Law General Attorney (Tax) CC:TEGE:PCCM:LA

from: Harry Beker
Branch Chief
CC:TEGE:EB:HW

subject: **Injury and Disability Plan**

This Chief Counsel Advice responds to your memorandum dated June 2, 2003. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Plan = Injury and Disability Plan

ISSUES

Whether the Plan meets the requirements of section 105(c) of the Internal Revenue Code?

CONCLUSIONS

After reviewing the Plan document and related material, we believe that our primary argument should be that amounts paid for permanent disability under the Plan are not excludable under section 105(c) but are includible in gross income under section 105(a).

LAW AND ANALYSIS

Section 105(c) provides that gross income does not include amounts that (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of the taxpayer, and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

Each part of section 105(c) must be satisfied before payments are excluded. Beisler v. Comm., 814 F. 2d 1304 (9th Cir. 1987). We believe the exception under section 105(c) does not apply to the disability payments received by the taxpayer for the following reasons:

Payments are not for the permanent loss or loss of use of a member or function of the body.

The taxpayer here suffered a coronary artery spasm and was declared permanently disabled. Courts have held that this type of condition does not qualify under section 105(c). In Watts v. U.S., 703 F.2d 346 (9th Cir. 1983), amounts received because of hypertension were not excludable because there was no loss of bodily function. Watts cited to §1.105-3 for the type of injuries covered by section 105(c) (i.e., “loss of use of an appendage of the body, loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears.”). The Ninth Circuit concluded that “hypertension has varying degrees of severity, and if hypertension is not sufficiently severe then it does not constitute a loss of body function.” The Court also distinguished its case from the holding in Rev. Rul. 63-181, 1963-2 CB 74, which held that a cancerous condition with a life expectancy of a few months resulted in total and permanent disability and constituted the permanent loss described in section 105(c).

In Hines v. Comm., 72 TC 715 (1981), a pilot who suffered a heart attack and lost the use of a part of his heart did not qualify for the exclusion under section 105(c) because this did not constitute a permanent loss or loss of use. The Court stated, “...if damage to the heart tissue is to qualify under section 105(c)(1) it must be equivalent to the loss of a bodily function. Although in a technical sense the functions of a particular portion of the statute.”

Similarly, in King v. Comm., T.C. Memo 1996-52, the Tax Court held that “... petitioner’s hear condition, like that of the pilot in Hines v. Comm. ... does not qualify as a permanent loss or loss of use of a member of function of the body...”

Section 105(c) is inapplicable if a person is entitled to a disability payment where there is a loss of work function and not a loss of a member or the body or body function.

The Plan defines “permanent disability” in Section 6.1 as the “inability or incapacity of an Employee to perform any significant portion of the Employee’s duties for or on behalf of the company...” Because the Plan defines disability in terms of a condition that renders the participant incapable of satisfactorily performing his duties with the employer, section 105(c) is not satisfied.

In Watts, as here, the plan defined permanent disability in terms of the loss of work function. The Ninth Circuit stated that the taxpayer’s “evidence that he has become permanently incapable of performing a work function does not meet the requirements of section 105(c)...” The Court concluded that, “...payment for the loss of a work function does not constitute payment for the loss of a body function.” Also, in Hines, the Tax Court

specifically rejected the contention that the inability to perform one's chosen career is tantamount to a loss of body function under section 105(c).

Another section 105(c) requirement is that payments must be computed with reference to the nature of the injury. Benefits are excludable "only if paid by a plan that varies the amount to payment according to the type and severity of the injury suffered by the employee." Beisler v. U.S., 814 F. 2d 1304 (9th Cir. 1987).

Although the Plan has an injury-specific scale of payments in Section 8.1, the amount payable for "permanent disability" under Section 8.2 is not computed with respect to the severity of the disability. In fact, Section 6.1 of the Plan specifically provides that "permanent disability" included, "without limitation" all of the following illnesses which receive the same amount of payment regardless of severity: "cancerous condition, heart attack, heart condition, stroke, paralysis, and acute or chronic illness."

In Beisler, the Ninth Circuit stated that "...under the NFL Plan all players who sustain career-ending injuries...receive the same disability payment, regardless of the type of injury suffered. The plan makes no attempt to distinguish among the various 'substantial disablements' even though the type of severity of these injuries can vary greatly."

In Rosen v. U.S., 829 F.2d 506 (4th Cir. 1987), the Court held that payments vary according to the nature of the injury only when such payments are calculated with regard to the type and severity of the injury and not merely the resulting disability. Also, in Cash v. Comm., T.C. Memo 1994-166, the Tax Court concluded that, "...petitioner received benefits under the policy because it was determined that as a result of the stroke suffered, he was permanently and totally disabled. Under the policy... it did not matter as to the underlying reason for the disability. Therefore, such payments may not be excluded from gross income."

Note also that Section 6.3 of the Plan relies heavily on Hines to the effect that the intent of section 105(c) was to provide benefits to "one who receives a severe physical injury which permanently and significantly lessens the quality of life which he had enjoyed prior to the injury." The Ninth Circuit in Watts specifically rejected this reading of section 105(c): "We do not adopt the tax court's view... The statute does not address the loss of a quality of life previously enjoyed."

In addition to lacking a disability-specific scale of payment, the Plan also determines payments on lengths of service which is impermissible.

Section 1.6 of the Plan divides participants into four Groups based on whether the participant is a "licensed attorney" and the length he or she has been "practicing law." The benefit payable under Section 9 is based on a percentage applicable to a participant's applicable Group.

Disability payments based on the taxpayer's length of service are includible in gross income. In Beisler, the disability payments made to a football player were determined by the number of years the retiree played football and not on the type and severity of the injury. The Ninth Circuit held that the payments were not excludable under section 105(c).

In West v. Comm. T.C. Memo 1992-617, the Tax Court concluded that because the taxpayer's benefits were based on the number of years of service at the time of the accident, the payments were not based upon the type and severity of the injury as required by section 105(c)(2). Chernik v. Comm., T.C. Memo 1999-313 stated that, petitioner's salary and his years of service with the City and did not vary depending on the injury or illness suffered." Also, in Berman v. Comm., 925 F2d 936 (6th Cir. 1991), injury where amount was based on employee's salary, years of service, and extent to which his benefits vested at the time of injury.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

We hope this memorandum is helpful. If you need additional assistance, please call me or Malcolm Funn at 202-622-6080.