Fernandez v. Commissioner, 138 T. C. 378 (U. S. Tax Ct. 2012)

In Fernandez v. Commissioner, the U. S. Tax Court ruled that payments received by Shannon L. Fernandez from her former husband's disability retirement benefits under a divorce agreement were taxable income. The court rejected Fernandez's argument that the payments should be tax-exempt under I. R. C. sec. 104(a)(1), clarifying that the tax treatment applicable to the original recipient of disability benefits does not automatically extend to a former spouse receiving a portion of those benefits via a divorce settlement. This decision underscores the narrow interpretation of tax exclusions and the importance of specific statutory language in determining tax liabilities from retirement distributions.

Parties

Shannon L. Fernandez, Petitioner, was represented by J. Christopher Toews. The Commissioner of Internal Revenue, Respondent, was represented by Kris H. An and Laura Beth Salant.

Facts

Shannon L. Fernandez received a portion of her former husband's disability retirement benefits from the Los Angeles County Employees Retirement Association (LACERA) pursuant to a divorce agreement. The agreement, which was treated as a qualified domestic relations order (QDRO), awarded Fernandez a percentage of her former husband's retirement benefits. During the 2007 tax year, Fernandez received $11,850 from LACERA, with $11,691 reported as taxable income on a Form 1099-R. Fernandez did not include any of this amount in her 2007 federal income tax return, leading to a deficiency determination by the IRS.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to Fernandez on December 28, 2009, determining a $3,587 income tax deficiency for 2007 due to the unreported income from LACERA. Fernandez timely petitioned the U. S. Tax Court for a redetermination of the deficiency on February 2, 2010. The case was submitted fully stipulated under Rule 122 of the Tax Court Rules of Practice and Procedure.

Issue(s)

Whether the $11,691 received by Fernandez from LACERA, pursuant to a divorce agreement, is excludable from her gross income under I. R. C. sec. 104(a)(1)?

Rule(s) of Law

I. R. C. sec. 61(a) defines gross income as all income from whatever source derived, including pensions, unless otherwise provided. I. R. C. sec. 104(a)(1) provides an exclusion for amounts received under workmen's compensation acts as compensation for personal injuries or sickness. I. R. C. sec. 402(e)(1)(A) treats an alternate payee under a QDRO as the distributee of any distribution or payment for purposes of I. R. C. sec. 402(a) and sec. 72, but does not reference sec. 104(a).

Holding

The Tax Court held that the $11,691 received by Fernandez from LACERA is not excludable from her gross income under I. R. C. sec. 104(a)(1). The court found that the statutory language of sec. 402(e)(1)(A) does not extend the exclusion under sec. 104(a)(1) to an alternate payee receiving benefits under a QDRO.

Reasoning

The court's reasoning focused on the strict construction of statutory exclusions from gross income. It emphasized that sec. 104(a)(1) exclusions are construed narrowly and only apply to compensation for personal injuries or sickness received by the injured party. The court noted that sec. 402(e)(1)(A) explicitly refers to sec. 402(a) and sec. 72 but does not mention sec. 104(a), indicating that Congress did not intend for the exclusion to apply to alternate payees under a QDRO. The court also rejected Fernandez's argument that she should step into her former husband's shoes for tax treatment, as she did not suffer the personal injury for which the disability benefits were awarded. The court found no relevant law supporting Fernandez's position and adhered to the principle that all income is taxable unless explicitly excluded by statute.

Disposition

The Tax Court entered a decision for the Commissioner, affirming the deficiency determination and finding the $11,691 taxable to Fernandez.

Significance/Impact

Fernandez v. Commissioner clarifies the tax treatment of retirement benefits distributed pursuant to divorce agreements and treated as QDROs. It reinforces the principle that tax exclusions must be explicitly provided by statute and cannot be inferred from provisions designed for other purposes. This decision has implications for the tax planning of divorcing parties who receive portions of their former spouse's retirement benefits, emphasizing the need to consider the tax implications of such distributions carefully. It also highlights the limitations of QDRO protections in altering the tax treatment of retirement benefits for alternate payees.

