***26 T.C. 1221 (1956)***

Retirement pay for military personnel is only excludable from gross income under Section 22(b)(5) of the Internal Revenue Code if it is specifically designated as compensation for injuries or sickness resulting from active service, and not based on age or length of service.

**Summary**

In McNair v. Commissioner, the U.S. Tax Court addressed whether a retired Navy commander's pay allowance was taxable income. The taxpayer, retired for length of service, was later recalled to active duty and developed tuberculosis. The Navy, however, continued his retirement pay based on his years of service, not disability. The court held that because the retirement pay was calculated based on length of service, it was not excludable from gross income under Section 22(b)(5) of the Internal Revenue Code, which provides an exclusion for disability-related payments. The court distinguished this case from one where a retirement board had made a specific finding of disability and underscored that the nature of the payment, not the underlying medical condition, determined its taxability.

**Facts**

Frederick V. McNair entered the U.S. Navy in 1899 and retired on June 30, 1931, due to length of service, not disability. He was recalled to active duty on April 10, 1941, and was found physically qualified. On August 25, 1942, he was diagnosed with tuberculosis, which a medical board attributed to his recall to active duty. The Board of Medical Survey recommended retirement, but the Navy determined it lacked jurisdiction to reclassify his retirement pay as disability-related, since his existing retirement pay based on length of service was the maximum allowed. McNair was released from active duty on November 1, 1942, yet continued to receive retirement pay based on his prior years of service. The IRS subsequently asserted deficiencies for the years 1950-1953, arguing that the retirement pay was taxable income.

**Procedural History**

The case originated in the U.S. Tax Court. The Commissioner of Internal Revenue asserted income tax deficiencies against Frederick and Agnes McNair for the tax years 1948-1953. The Tax Court consolidated the cases for trial and opinion because the legal issues in the cases were identical. Due to the statute of limitations running, the case focused on the tax years of 1950-1953. The Tax Court ruled in favor of the Commissioner, determining the retirement payments to be taxable income.

**Issue(s)**

1. Whether the retirement pay received by McNair during 1950-1953 was excludable from gross income as amounts received as a pension, annuity, or

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similar allowance for personal injuries or sickness resulting from active service in the Navy.

## Holding

1. No, because McNair's retirement pay was based on his length of service, not on any injuries or sickness sustained during active service.

## Court's Reasoning

The court relied on Section 22(b)(5) of the Internal Revenue Code of 1939, which permits the exclusion from gross income for amounts received as a pension, annuity, or allowance for personal injuries or sickness resulting from active service in the armed forces. The court emphasized that McNair was originally retired for length of service. Even though he contracted tuberculosis after being recalled, his retirement pay continued to be calculated based on length of service, and was not reclassified to disability pay. Therefore, the court determined that the pay did not fall under the exclusion. The court distinguished this case from the case of *Prince v. United States*, where the taxpayer's case had been brought before the retirement board and a finding of disability was made. The court explicitly stated, "We must view the situation as it is."

## Practical Implications

This case clarifies that the *basis* for calculating retirement pay is crucial for determining its taxability. Attorneys advising military retirees must examine not only the retiree's medical condition but also the specific legal basis for the retirement pay to determine its tax status. If the payments are based on length of service, even if a disability exists, they are typically taxable. This distinction has practical implications for tax planning, financial advice, and legal disputes involving military retirement benefits. Later cases will likely cite this one in similar situations where the nature of the retirement pay calculation is at issue.

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