Cleary v. Commissioner, 60 T. C. 133 (1973)

Military retirement pay cannot be retroactively excluded from gross income based on a subsequent VA disability rating without a timely waiver of retirement pay.

Summary

Fred K. Cleary, a retired Army officer, sought to exclude portions of his retirement pay from 1967 and 1969 from his gross income after the Veterans Administration (VA) awarded him a 20% disability rating retroactive to his retirement date. The Tax Court ruled that Cleary's retirement pay was not excludable under IRC sections 104(a)(4) or 105(d) because he had not waived any portion of his retirement pay until after receiving the VA rating, and thus could not retroactively exclude previously received retirement pay. The decision underscores the necessity of a timely waiver to apply VA compensation rules to military retirement income.

Facts

Fred K. Cleary retired from the U. S. Army on September 30, 1967, due to longevity after over 22 years of service and began receiving retirement pay. On the same day, he applied for VA disability compensation, which was initially denied in May 1968. After an appeal, the VA awarded him a 20% disability rating effective from October 1, 1967, but notified him in January 1970. Cleary waived a portion of his retirement pay equal to the VA compensation on January 24, 1970, and started receiving disability payments from April 1970. He sought to exclude portions of his 1967 and 1969 retirement pay from his gross income based on this VA award.

Procedural History

Cleary filed joint federal income tax returns for 1967 and 1969 and an amended return for 1967. After receiving the VA disability rating, he claimed exclusions on his returns, resulting in refunds. The Commissioner of Internal Revenue determined deficiencies for those years, leading Cleary to petition the U. S. Tax Court. The court held in favor of the Commissioner, ruling that no portion of Cleary's retirement pay for 1967 and 1969 was excludable from gross income.

Issue(s)

1. Whether Cleary is entitled to exclude from gross income, pursuant to IRC section 104(a)(4), any portion of his Army retirement pay for 1967 and 1969 based on a subsequent VA disability rating.
2. Whether Cleary is entitled to exclude from gross income, pursuant to IRC section 105(d), any portion of his Army retirement pay for 1967 and 1969 not excluded under IRC section 104(a)(4).

Holding

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1. No, because Cleary did not waive any portion of his retirement pay until January 24, 1970, after he had already received the retirement payments for 1967 and 1969, and thus could not retroactively exclude them from gross income under IRC section 104(a)(4).
2. No, because Cleary's retirement pay was not received under an accident or health insurance plan, nor was it received for a period during which he was absent from work due to personal injury or sickness, as required by IRC section 105(d).

Court's Reasoning

The court reasoned that under IRC section 104(a)(4), only amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service can be excluded from gross income. Cleary's retirement pay was based on longevity, not disability, and he did not waive any portion of it until after receiving the VA rating. The court emphasized that the statutory framework requires a waiver of retirement pay to receive VA compensation, and such a waiver could not retroactively affect previously received retirement payments. Regarding IRC section 105(d), the court found that Cleary's retirement pay did not qualify as wages or payments in lieu of wages for absence due to illness or injury, as he continued working after retirement and was not incapacitated. The court also noted the annual basis of tax liability and the absence of legal principle allowing retroactive transformation of retirement pay into VA compensation.

Practical Implications

This decision clarifies that military retirees cannot exclude their retirement pay from gross income based on a subsequent VA disability rating unless they waive a portion of their retirement pay at the time of receiving VA compensation. It emphasizes the importance of timely action in filing waivers to apply VA compensation rules to military retirement income. For legal practitioners, this case highlights the need to advise clients on the tax implications of VA disability ratings and the necessity of coordinating retirement pay waivers with VA compensation claims. It also has broader implications for understanding the interplay between military retirement benefits and VA disability compensation, influencing how similar cases are analyzed and how veterans plan their financial and tax strategies.

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