Brownholtz v. Commissioner, 71 T. C. 332 (1978)

Disability retirement payments cannot be excluded from income as both sick pay under IRC section 105(d) and as recovery of employee contributions under IRC section 72(d) in the same year.

Summary

William Brownholtz, a retired U. S. Civil Service employee on disability, sought to exclude his 1973 annuity payments as both sick pay and recovery of his contributions to the Civil Service Retirement System. The Tax Court held that such dual exclusions were not permissible under the applicable IRS regulations, specifically section 1. 72-15(i), which allowed the greater of the two exclusions but not both. The court upheld the Commissioner's disallowance of the sick pay exclusion, affirming that Brownholtz could only exclude the larger amount under section 72(d). This decision clarified that disability payments cannot be split into different tax treatments within the same tax year.

Facts

William Brownholtz retired from the U. S. Public Health Service on March 31, 1972, at age 57 after 37. 5 years of service. He had been disabled since 1966. His retirement status was changed to disability retirement effective April 1, 1972, without any change in his annuity rate. In 1973, Brownholtz received $18,801 in retirement payments. He attempted to exclude $5,200 of this amount as sick pay under IRC section 105(d) and the remaining $13,601 as recovery of his contributions to the retirement system under IRC section 72(d). His total contributions to the system were $22,053, with $8,114 recovered in 1972, leaving $13,939 to be recovered.

Procedural History

The Commissioner determined a deficiency in Brownholtz's 1973 federal income taxes and disallowed the $5,200 sick pay exclusion, allowing only the $13,601 exclusion under section 72(d). Brownholtz and his wife filed a petition with the United States Tax Court challenging this determination. The Tax Court upheld the Commissioner's decision, ruling that Brownholtz could not claim both exclusions in the same year.

Issue(s)

1. Whether a taxpayer can exclude disability retirement payments from gross income as both sick pay under IRC section 105(d) and as recovery of employee contributions under IRC section 72(d) in the same year.

Holding

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1. No, because under IRS regulation section 1. 72-15(i), a taxpayer can only exclude the greater of the amount claimed under section 72(d) or the maximum permissible sick pay exclusion under section 105(d), but not both.

Court's Reasoning

The court relied on IRS regulation section 1. 72-15(i), which specifies that for taxable years ending before January 27, 1975, a taxpayer can exclude either the amount actually excluded under section 72(d) or the amount that would be excludable under section 105(d), but not both. The court emphasized that this regulation was consistent with the general rule in sections 1. 72-15(b) and (d), which states that section 72 does not apply to amounts received as accident or health benefits, which are instead governed by sections 104 and 105. The court rejected Brownholtz's arguments that the regulation was invalid, noting that without it, the general rule would be even more restrictive. The court also referenced prior case law, such as *DePaolis v. Commissioner*, which supported the principle that disability payments should not be fractured into different tax treatments within the same year. The court further noted that subsequent legislative changes, such as the Tax Reform Act of 1976, reinforced the interpretation that dual exclusions were not intended by Congress.

Practical Implications

This decision impacts how attorneys should advise clients receiving disability retirement payments. It clarifies that such payments cannot be treated as both sick pay and annuity recovery in the same tax year, which is crucial for tax planning and compliance. Legal practitioners must ensure clients are aware of the need to choose the more favorable exclusion method. The ruling also affects how the IRS applies regulations and statutes to similar cases, emphasizing the importance of following IRS guidelines on exclusions. Businesses offering disability retirement plans should consider these tax implications when structuring their benefits. Subsequent cases, such as *Jones v. Commissioner*, have applied this ruling, confirming its ongoing relevance in tax law.

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