***William I. Woodford and Madge L. Woodford, Petitioners v. Commissioner of Internal Revenue, Respondent, 71 T. C. 991 (1979)***

Disability retirement payments received before normal retirement age are treated as wages or payments in lieu of wages, subject to tax under section 105(a) rather than as a recovery of employee contributions under section 72(d).

**Summary**

William I. Woodford, a retired federal employee, received disability retirement payments before reaching the normal retirement age of 70. He sought to exclude these payments from his gross income both as sick pay under section 105(d) and as a recovery of his contributions to the Civil Service Retirement Fund under section 72(d). The Tax Court held that these payments could not be split for tax purposes and were taxable as wages under section 105(a), thus disallowing the exclusion under section 72(d). Additionally, the court ruled that these payments constituted earned income, disqualifying Woodford from claiming a retirement income credit under section 37. This decision clarifies the tax treatment of disability retirement benefits received before normal retirement age and impacts how such benefits are reported on tax returns.

**Facts**

William I. Woodford retired from the Internal Revenue Service at age 67 after 29 years of service. Initially, his retirement was classified as nondisability, but it was later reclassified to disability retirement effective November 4, 1974. In 1975, he received $10,879 in disability retirement benefits and excluded $5,200 as sick pay under section 105(d). He also sought to exclude an additional $5,679 as a recovery of his contributions to the Civil Service Retirement Fund under section 72(d). Woodford and his wife also claimed a retirement income credit of $228. 60 for 1975.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in the Woodfords' 1975 federal income tax and disallowed the exclusion of the $5,679 and the retirement income credit. The Woodfords petitioned the Tax Court, which upheld the Commissioner's determination, ruling that the disability retirement payments were taxable under section 105(a) and constituted earned income, thus disallowing the claimed exclusions and credit.

**Issue(s)**

1. Whether petitioners are entitled to exclude from their gross income the $5,679 in excess of the sick pay exclusion as a recovery of their contributions to the Civil Service Retirement Fund under section 72(d)(1).
2. Whether petitioners are entitled to a retirement income credit under section 37 for 1975.

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## Holding

1. No, because the disability retirement payments in excess of the sick pay exclusion are treated as wages under section 105(a) and cannot be excluded under section 72(d)(1).
2. No, because the disability retirement payments constitute earned income under section 37(d)(2)(B), disqualifying petitioners from the retirement income credit.

## Court’s Reasoning

The Tax Court applied sections 105(a) and 105(d) to determine that the disability retirement payments were wages or payments in lieu of wages, taxable under section 105(a) and not subject to exclusion under section 72(d). The court relied on section 1. 72-15(b) of the Income Tax Regulations, which states that section 72 does not apply to amounts received as accident or health benefits, and on the DePaolis and Brownholtz cases, which established that such payments cannot be split for tax purposes. The court also found that these payments were earned income under section 37(g), thus disqualifying the Woodfords from the retirement income credit. The decision reflects the policy of taxing wage continuation benefits provided by untaxed employer contributions during periods of absence due to sickness.

## Practical Implications

This decision affects how federal employees and other taxpayers report disability retirement benefits received before normal retirement age on their tax returns. It clarifies that such benefits are taxable as wages under section 105(a) and cannot be excluded under section 72(d) as a recovery of contributions. Taxpayers must be aware of the limitations on exclusions and credits, such as the retirement income credit, when receiving disability benefits. This ruling may influence the structuring of retirement plans and the tax advice given to employees considering disability retirement. Subsequent cases have followed this precedent, reinforcing the tax treatment of disability retirement benefits before normal retirement age.

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