Pearson v. Commissioner, 76 T. C. 709 (1981)

The disability income tax exclusion under section 105(d) applies only to individuals who were permanently and totally disabled at the time of retirement or on January 1, 1976.

Summary

Donald B. Pearson, a retired U. S. Air Force member, sought to exclude $5,220 of his 1977 income under section 105(d) of the Internal Revenue Code, which provides for a disability income exclusion. The Tax Court held that Pearson was not entitled to this exclusion because he was not permanently and totally disabled at the time of his retirement or on January 1, 1976, as required by the amended section 105(d). This decision underscores the importance of meeting specific criteria for tax exclusions and highlights the impact of legislative changes on existing tax provisions.

Facts

Donald B. Pearson retired from the U. S. Air Force on May 1, 1970, due to a 10% disability and began receiving retirement pay. In 1977, he reported a taxable amount of $10,886. 84 from his Air Force retirement and $18,687. 48 from employment at Kensinger Sound Studios, Inc. Pearson claimed a disability income exclusion of $5,220 on his 1977 tax return, citing his retirement due to physical disability. However, he was not permanently and totally disabled at the time of his retirement or on January 1, 1976, or January 1, 1977.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Pearson’s 1977 federal income tax and disallowed his claimed disability income exclusion. Pearson filed a petition with the U. S. Tax Court, which upheld the Commissioner’s determination and ruled in favor of the respondent.

Issue(s)

1. Whether Pearson is entitled to a disability income tax exclusion for the calendar year 1977 under section 105(d) of the Internal Revenue Code, as applicable to years beginning after December 31, 1976.

Holding

1. No, because Pearson was not permanently and totally disabled at the time of his retirement or on January 1, 1976, as required by the amended section 105(d).

Court’s Reasoning

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The Tax Court's decision hinged on the interpretation of section 105(d) of the Internal Revenue Code, as amended by the Tax Reform Act of 1976. The court noted that the amended section 105(d) allows a disability income exclusion only for individuals who were permanently and totally disabled when they retired or on January 1, 1976. The court referenced the Senate Finance Committee's report, which explained the intent to limit the exclusion to those with severe disabilities. Pearson's claim was denied because he did not meet this criterion. The court also emphasized the clarity of the law and the legislative intent to replace the prior, less restrictive sick pay exclusion with the new, more stringent disability income exclusion for years beginning after December 31, 1976. The court quoted from the proposed Income Tax Regulations, which further clarified that the new exclusion applies only to those meeting the permanent and total disability requirement.

Practical Implications

This decision clarifies that the disability income tax exclusion under section 105(d) is strictly limited to individuals who were permanently and totally disabled at the time of retirement or on a specific date (January 1, 1976). Tax practitioners must carefully assess their clients' disability status at these critical junctures to determine eligibility for this exclusion. The ruling underscores the impact of legislative changes on tax benefits and highlights the need for taxpayers to stay informed about amendments to tax laws. It also serves as a reminder that prior allowances under different regulations do not guarantee future eligibility under new laws. Subsequent cases, such as those involving similar exclusions, may need to consider this precedent when interpreting statutory requirements for tax benefits.

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