Sewards v. Commissioner, 133 T. C. 78 (2009)

In Sewards v. Commissioner, the U. S. Tax Court ruled that only the guaranteed portion of Jay Sewards' service-connected disability (SCD) retirement payments was excludable from gross income under Section 104(a)(1) of the Internal Revenue Code. The decision clarified that any amount exceeding the guaranteed benefit, which was based on Sewards' length of service, must be included in taxable income. Additionally, the court found that the taxpayers acted in good faith and thus were not liable for an accuracy-related penalty under Section 6662(a). This case underscores the nuanced tax treatment of disability retirement benefits and the importance of good faith efforts in tax reporting.

Parties

Jay Sewards and his spouse, referred to collectively as petitioners, were the taxpayers challenging the tax treatment of Mr. Sewards' retirement payments. The respondent was the Commissioner of Internal Revenue, representing the Internal Revenue Service (IRS).

Facts

Jay Sewards was employed by the Los Angeles County Sheriff's Department for over 34 years before being placed on involuntary medical disability leave due to service-connected injuries in November 2000. During his disability leave, he received his full salary of $14,093 per month. In July 2001, Sewards elected a service retirement effective October 31, 2001, which provided him with a monthly payment of $12,861 based on his length of service. In May 2002, he applied for and was granted a service-connected disability (SCD) retirement retroactive to October 31, 2001, replacing his service retirement. The SCD retirement provided a guaranteed benefit of half his final compensation ($7,046 per month) or his full service retirement amount, whichever was higher. Sewards received the higher amount of $12,861 per month. The Los Angeles County Employees Retirement Association (LACERA) initially did not report a taxable amount on Forms 1099-R for 2001 through 2005 but later informed Sewards in 2006 that 50% of his final compensation would be reported as taxable. On their 2006 joint Federal income tax return, the Sewards did not report any portion of the SCD retirement payments as taxable, leading to a deficiency notice and penalty from the IRS.

Procedural History

The Commissioner of Internal Revenue issued a statutory notice of deficiency to the Sewards, determining that a portion of Mr. Sewards' SCD retirement payments was taxable and asserting a section 6662(a) accuracy-related penalty. The Sewards, residing in Port Ludlow, Washington, filed a petition with the U. S. Tax Court on October 1, 2008. The case was submitted fully stipulated under Tax Court Rule 122. The Tax Court's decision was entered under Rule 155, indicating that the court

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would calculate the exact amount of the deficiency based on the legal conclusions reached in the opinion.

Issue(s)

Whether the portion of Jay Sewards' service-connected disability retirement payments that exceeded the guaranteed amount is excludable from gross income under Section 104(a)(1) of the Internal Revenue Code?

Whether the Sewards are liable for a section 6662(a) accuracy-related penalty due to the underpayment of their 2006 Federal income tax?

Rule(s) of Law

Section 104(a)(1) of the Internal Revenue Code and the regulations thereunder (Section 1. 104-1(b), Income Tax Regs.) provide that retirement payments are excludable from gross income if received pursuant to a workmen's compensation act or a statute in the nature of a workmen's compensation act. However, this exclusion does not apply to the extent the payments are determined by reference to the employee's age, length of service, or prior contributions. Section 6662(a) and (b)(2) of the Internal Revenue Code impose a 20% accuracy-related penalty on any underpayment of tax attributable to a substantial understatement of income tax, unless there was reasonable cause for the underpayment and the taxpayer acted in good faith, as provided by Section 6664(c)(1).

Holding

The Tax Court held that the portion of Jay Sewards' service-connected disability retirement payments that exceeded the guaranteed amount of $7,046 per month, which was determined by reference to his length of service, is not excludable from gross income under Section 104(a)(1). The court further held that the Sewards are not liable for a section 6662(a) accuracy-related penalty because they had reasonable cause for the underpayment and acted in good faith.

Reasoning

The court reasoned that while the statute authorizing Sewards' SCD retirement payments was in the nature of a workmen's compensation act, the payments were partially determined by his length of service. The court cited Section 1. 104-1(b) of the Income Tax Regulations, which states that payments determined by reference to age, length of service, or prior contributions are not excludable under Section 104(a)(1). The court distinguished the case from Picard v. Commissioner, noting that Sewards' higher benefit was based on his service retirement, which was calculated by his length of service, not merely his age or date of hire. Regarding the penalty, the court considered the varying guidance from LACERA over several years and found that the Sewards made a good faith effort to assess their tax liability, thus qualifying for the reasonable cause exception under Section 6664(c)(1). The court's

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analysis included consideration of the regulatory language, the specific facts of Sewards' retirement plan, and the good faith efforts of the taxpayers in light of ambiguous guidance from LACERA.

Disposition

The Tax Court decided that the portion of the SCD retirement payments exceeding the guaranteed amount was taxable and that the Sewards were not liable for the accuracy-related penalty. The case was to be resolved under Rule 155, with the court to calculate the exact tax deficiency.

Significance/Impact

Sewards v. Commissioner is significant for its clarification of the tax treatment of service-connected disability retirement benefits under Section 104(a)(1). The ruling establishes that only the guaranteed portion of such benefits is excludable from income if the higher benefit is determined by factors like length of service. This decision impacts how taxpayers and retirement plan administrators should report and calculate the taxability of disability retirement payments. Furthermore, the case underscores the importance of good faith efforts in tax reporting, as the court's decision not to impose the accuracy-related penalty highlights the relevance of reasonable cause and good faith in tax disputes. Subsequent cases and IRS guidance may reference Sewards when addressing similar issues regarding the taxation of disability retirement benefits and the application of penalties for tax underpayments.

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