

tion under section 165(a) to losses incurred in a trade or business, losses incurred in transactions entered into for profit, and casualty losses.

The United States Tax Court has consistently held that a taxpayer may not take a loss with respect to an income item, as distinguished from a capital item, unless the income has been actually received and previously reported on a tax return. See e.g. *Alsop v. Commissioner*, 34 T.C. 606 (1960), *aff'd*, 290 F.2d 726 (2d Cir. 1961); and *O'Meara v. Commissioner*, 8 T.C. 622 (1947).

Rev. Rul. 78-161, 1978-1 C.B. 31, announced that the Internal Revenue Service will follow the decision of the United States Court of Appeals for the Fourth Circuit in *Strickland v. Commissioner*, 540 F.2d 1196 (4th Cir. 1976), as precedent in the disposition of similar cases involving section 104(a)(4) of the Code.

In *Strickland*, the court held that the Veterans' Administration's retroactive determination that the taxpayer was eligible for disability benefits was controlling. Thus, the taxpayer was entitled to exclude from gross income, under section 104(a)(4) of the Code, part of the payments previously received as retirement pay based on the rank and length of service.

This case is distinguishable from *Strickland* because the readjustment pay was not intended by the military and the taxpayer to be one of a series of periodic payments. Section 104(a)(4) of the Code does not exclude amounts if they are not received as a pension, annuity, or similar allowance; and an amount is not received for the purposes of section 104(a)(4), as a pension, annuity, or similar allowance if it was not intended by its payor to be one of a series of periodic payments.

This case is also distinguishable from *Strickland* because with respect to readjustment pay, the legislative history of 10 U.S.C. section 687(b)(6) indicates that Congress intended that a retroactive award of Veterans' Administration disability compensation would

not allow a taxpayer to obtain a double tax benefit by excluding from gross income any readjustment pay received from the military. See S. Rep. No. 1096. There is no such language in the case of retirement pay.

Finally, section 104(b)(4) of the Code does not apply to this case because the reference in that section to amounts that are excludable for any period does not include an amount that is not intended by the payor and recipient to be one of a series of periodic payments.

The taxpayer is considered as never having received the withheld disability compensation. This position is consistent with Rev. Rul. 67-350, 1967-2 C.B. 58, which deals with a reduction in military retirement pay to offset a previously received lump-sum readjustment payment, under a law similar to 10 U.S.C. 687(b)(6). It was there held that there was no constructive receipt of the withheld retirement pay. Because the disability compensation is not received by the taxpayer, the taxpayer cannot take a loss deduction as a result of the withholding of any disability compensation.

Furthermore, even if the withheld disability compensation were regarded as the taxpayer's repayment *pro tanto* of the severance pay previously received and subjected to tax, a loss may nevertheless not be allowed.

S. Rep. No. 1096 indicates that Congress intended that taxpayers would not be able to take any deductions as a result of the recoupment of readjustment pay. Congress limited the recoupment to 75 percent of the readjustment pay so as to avoid recoupment of an amount in excess of the net amount after tax received by a taxpayer, assuming an average tax bracket of 25 percent. Such a limitation would not have been necessary if the recoupment were to give rise to a loss deduction.

HOLDINGS

ISSUE 1

The taxpayer may not exclude from

gross income under section 104(a)(4) of the Code, as a result of the Veterans' Administration award, any portion of the readjustment pay that was received from the military.

ISSUE 2

Because the taxpayer has suffered no deductible loss as a result of the Veterans' Administration recoupment provision, the taxpayer is not allowed any deduction under section 165 of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-161 is distinguished.

26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Whether retirement benefits paid to disabled firefighters are includible in gross income. See Rev. Rul. 80-14, page 33.

26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

The amount includible in the gross income of an employee of a barter club who receives wages in cash and in credit units. See Rev. Rul. 80-52, page 100.

26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Whether compensation received by a taxpayer disabled in the line of duty, when the taxpayer is performing "light duty" for the municipality making the payments, is includible in gross income. See Rev. Rul. 80-137, page 36.

26 CFR 1.61-4: Gross income of farmers.

Whether sale of a wheat crop that was redeemed after being pledged as collateral for a Commodity Credit Corporation loan was a sale of a capital asset. See Rev. Rul. 80-19, page 185.

26 CFR 1.61-4: Gross income of farmers.

Whether transportation-in costs are part of the cost of livestock that is deducted when the livestock are sold by a farmer using the cash receipts and disbursement method of accounting. See Rev. Rul. 80-102, page 108.