



Appeal of **Bertram** D. and Glorian B. Thomas

The issue presented is whether certain monthly retirement income received by **Bertram** D. Thomas (hereinafter "appellant") was subject to taxation by California.

Before his retirement in May 1968, appellant was a resident of Ohio and was employed by Batelle Memorial Institute ("the Institute") in Columbus, Ohio. During his employment with the Institute, both he and his employer contributed to the Batelle Pension Plan (BPP). Appellant also elected to have his salary reduced for a number of years so that the Institute could purchase annuities for him from Teacher's Insurance and Annuity Associations of America (TIAA) and College Retirement Equities Fund (CREF).

Upon his retirement, appellant became eligible to receive retirement benefits under the three programs. In each case, he elected a joint and survivor annuity, payable monthly for the life or lives of designated persons, with a guaranteed payment period of 120 months.

Under BPP, each monthly payment consisted of a fixed-dollar amount and a variable amount which depended on the fund's investment experience. Upon appellant's **death**, his wife would receive reduced monthly payments for her life equal to 75 percent of the **amount** which would have been received if appellant had lived. If neither survived the 120-month guaranteed period, appellants' descendants, or the estate of the last survivor, would receive the reduced amounts for the remainder of the guaranteed period.

The TIAA annuity provided monthly payments of a fixed-dollar amount as long as both spouses lived. When one spouse died, monthly payments of a reduced fixed-dollar amount would be made for the life of the survivor. If neither survived the **guaranteed period**, designated beneficiaries would receive the reduced monthly payments for the remainder of the guaranteed period. If a beneficiary died while receiving annuity payments, the then-present value of his or her share of the remaining annuity payments would be divided equally among the surviving beneficiaries or, if none survived, paid to the estate of the last to die.

Under the CREF annuity, appellant's monthly payments were based on a certain number of "annuity units," the value of which varied according to the fund's investment and participation experience. The annuity payments would continue upon the death of one

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or both spouses in the same manner as the TIAA annuity, based on a reduced number of annuity units. No dollar amount was guaranteed.

In 1968, shortly after Dr. Thomas' retirement, appellants moved from Ohio and became California residents. They received the monthly annuity payments from BPP, TIAA, and CREF, but did not report them as income on their joint **California personal** income tax returns. After auditing appellants' returns, respondent issued proposed assessments of additional tax for 1972, 1973, 1974, and 1975, including in their income the annuity payments they had received. Appellants protested and, after consideration, respondent revised its proposed assessments, excluding from appellants' income a portion of the BPP payments as the return of investment in the plan.<sup>1/</sup> Appellants then filed this appeal.<sup>2/</sup>

The fundamental statement of California's jurisdiction to tax the income of individuals is found in Revenue and Taxation Code section 17041. This section provides that the personal income tax is to be imposed on the entire taxable income of every resident of this state, regardless of the source of the income, and upon the income of nonresidents which is derived

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<sup>1/</sup> During the course of this appeal, respondent also conceded that employer contributions of **\$139,883.28** to BPP constitute part of appellant's cost investment in that plan for purposes of computing the exclusion ratio. It also conceded that employer contributions of **\$78,750.28** and **\$78,749.74**, made to the TIAA and CREF plans, respectively, were includable in appellants' cost investment in those plans. Since respondent, by these concessions, has apparently abandoned its initial position that no cost recovery is allowable because the contributions were not taxed by California previously (see Rev. & Tax. Code, § 17106, subd. (a)), we do not address that issue in this appeal.

<sup>2/</sup> Subsequent to the oral hearing in this appeal, respondent made several concessions, excluding from California tax the amounts of **\$107,676.00** and **\$30,277.24** from the BPP and TIAA annuities, respectively. No concessions were made regarding amounts received under CREF.

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from sources within California. The policy behind California's personal income taxation of residents is to ensure that individuals who are physically present in the state, enjoying the benefits and protections of its laws and government, contribute to its support regardless of the source of their income. (See Cal. Admin. Code, tit. 18, reg. **17014-17016(a)**.) Taxable income is gross income minus allowable deductions. (Rev. & Tax. Code, § 17073.) Annuities are specifically included in gross income. (Rev. & Tax. Code, §§ 17071 & 17101.)

Appellants contend, however, that their monthly annuity income is not taxable by California, even though they are residents of this state and **cash-basis** taxpayers, by reason of Revenue and Taxation Code section 17596, which states:

When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this State, as the **case** may be, income and deductions accrued prior to the change of status even though not otherwise **includible** in respect of the period prior to such change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

The basic argument made by appellants is that at least part of the annuity payments received, over the cost exclusions allowed by respondent, accrued while they were nonresidents. Therefore, they argue, section **17596** prohibits California from taxing that income.

Although the language of section 17596 is enigmatic, its purpose is clear. It is an attempt to provide a consistent means of allocating income to the appropriate taxable period where, solely because of a change in a taxpayer's residency status, California and another state make inconsistent claims to tax the same income on a basis other than the source of the **income**, e.g., residency status. In other words, section 17596 is an attempt to equitably treat taxpayers 'faced with double taxation on a non-source jurisdictional basis. When this situation does not exist, section 17596 is unnecessary and section 17041 applies.

A limit on the appropriate use of section 17596 was made clear in our opinions in Appeal of

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John J. and Virginia Baustian, decided March 7, 1979, Appeal of Ray R. and Nellie A. Reeves, decided June 28, 1979, and Appeal by Messer, decided December 9, 1980, **rehearing denied and opinion modified** June 23, 1981. In those appeals we held that the section was not applicable in cases of California-source income. We believe that such limits are appropriate and that section 17596 should not be applied in derogation of the general rule of section 17041, where to do so would not further the purpose for which the former section was enacted. It should not be construed as a means to exempt income from taxation, but as a method to contend with double taxation. Therefore, section 17596 is not applicable unless, where there has been a change in the taxpayer's residency status, California and another state are taxing the same income on a non-source basis.

In this way, all policies involved are satisfied. The taxpayer is not subjected to an unfair double taxation of income by two states and receives no wind-fall tax benefit; all cash-basis California residents who receive annuity income attributable to 'out-of-state personal services are treated the same: and California appropriately receives tax from one residing in this state and receiving the benefits and protections of California's government and laws. In previous appeals involving change of residence, we have, with the exceptions noted previously, applied section 17596. Those decisions are not in conflict with this analysis and are still pertinent to situations in which section 17596 properly applies under this analysis.

In the present appeal, since Ohio has not taxed, or even attempted to tax, appellants' annuity income, section 17596 is inapplicable and does not shield the income from taxation by California. Section 17041 is therefore applicable, and appellants are taxable on this income as residents.

**Subject** to the concessions made by respondent, the actions of the Franchise Tax **Board** in this matter are therefore sustained.

