BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
HERMAN AND SANDRA J. BARNATHAN)

Appearances:

For Appellants: Herman Barnathan, in pro. per.

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Herman and Sandra J. Barnathan against a proposed assessment of additional personal income tax in the amount of $208.35 for the year 1978. After filing this appeal, appellants paid the proposed assessment in full. Accordingly, pursuant to section 19061.1 of the Revenue and Taxation Code, the appeal is treated as an appeal from the denial of a claim for refund.

At issue is whether appellant Herman Barnathan was an "active participant" in the State Teachers' Retirement System pension plan at any time during 1978.

In September 1974, Herman Barnathan, then a part-time employee of Los Angeles Community College, became a member of the State Teachers' Retirement System (STRS) and began making contributions to its pension plan. In November 1977, he filed a termination of his STRS membership, but the termination was not processed until February 1978. In March 1978, he received a refund from STRS of $920.82 in contributions and $67.93 in interest. Appellant has submitted a letter from the STRS stating that the retirement system considered his termination to be effective in November 1977 notwithstanding the fact that the termination was not processed until February 1978.

Mr. and Mrs. Herman Barnathan (appellants) filed a. 1978 joint personal income tax return on which they claimed a $3,000 deduction for contributions to an individual retirement account (IRA). Upon audit of appellants' return, the Franchise Tax Board (respondent) disallowed the claimed IRA deduction for appellant-husband because his wage and tax statement for 1978 indicated he had been covered by a pension plan. Respondent issued a notice of proposed assessment of personal income tax. due. After consideration of appellants' protest, respondent affirmed its proposed assessment. This appeal followed.

Section 17240 of the Revenue and Taxation Code is the statutory authority for the IRA contribution deduction. This section, for the taxable year in question, provided, in pertinent part:

> (a) In the case of an individual, there is allowed as a deduction amounts paid in cash for the taxable year by or on behalf of such individual for his benefit--
>
> (1) To an individual retirement account described in Section 17530(a).
>
> * * *
>
> (b) (2) No deduction is allowed under subdivision (a) for an individual for the taxable year if for any part of such year--
>
> (A) He was an active participant in--
>
> (i) A plan described in Section 17501 which includes a trust exempt from tax under Section 17631.

The potentiality of a double tax benefit accruing indirectly to a taxpayer who could claim an IRA deduction for a particular year

and later also claim pension benefits accruing from contributions in that year to a pension plan also accorded tax benefits in that year is sufficient for the purposes of the statute to make that taxpayer an "active participant" and so to deny that taxpayer a deduction in that same year for contributions to an IRA. This principle is illustrated by Foulkes v. Commissioner, 638 F.2d 1105 (7th Cir. 1981); Frederick A. Chapman, 77 T.C. 477 (1981); Kenneth H. Smith, ¶ 81,644 P-H Memo. T.C. (1981); and Leon Thomsen, ¶ 81,685 P-H Memo. T.C. (1981).

Foulkes was employed from November 1970 to May 1975 by a company which maintained a qualified, noncontributory pension plan, and he was covered by that plan. Under the terms of the plan, Foulkes forfeited his right to benefits when he terminated his employment with that company. Later in 1975, Foulkes became employed by another company which had no pension plan for its employees. In December 1975, Foulkes opened an IRA with a $1,500 deposit. On his 1975 federal income tax return. Foulkes claimed a $1,500 IRA deduction. The IRS disallowed tne deduction on the grouno that Foulkes had been an "active participant" in a qualified pension plan for a period during 1975 and so was precluded from claiming an IRA deduction for that year. When the issue was presented to the Seventh Circuit Court of Appeals, that court noted that the administrator of the qualified pension plan had not elected to have certain federally specified break-in-service rules apply to the plan. Those rules generally provide that an employee who was once covered by a qualified plan and who terminates his employment but later returns to that employer, will not be a new employee under the plan. Rather, if certain requirements are satisfied, the employee will receive credit for time employed before termination. (Employee Retirement Income Security Act of 1974, § 1017(d), Pub. L. 93-406, 88 Stat. 829 (1974), as amended by Pub. L. 94-12, § 402, 89 Stat. 26 (1975); Int. Rev. Code of 1954, § 411(a)(6).) Therefore, the court noted, Foulkes would not have been able to receive credit for past time should he later return to work for the first employer, and no potential for a double tax benefit existed. The court emphasized that the Congressional purpose in denying an IRA deduction of an "active participant" of a qualified pension plan was to prevent potential double tax benefits. Since no potential double benefits for 1975 could accrue to Foulkes, the court concluded that the proper statutory construction required that Foulkes not be considered an "active participant" in 1975 of a qualified pension plan, and thus could receive the benefit of an IRA deduction.

In Chapman, the taxpayer had been an employee of Blue Cross/ Blue Shield of Massachusetts from April 26, 1971, to August 31, 1976. He participated in that employer's pension plan, from which he could not withdraw while remaining so employed. No benefits could vest until he had been an employee for ten years. When his employment ended, he forfeited all plan benefits.

Later that year he contributed $1,500 to an IRA and deducted the amount contributed on his income tax return for that year. The Internal Revenue Service denied that deduction. In the litigation which followed, the parties stipulated that the taxpayer would be entitled to a reinstatement of previously accrued benefits if he were re-employed by Blue Cross/Blue Shield of Massachusetts after 1976 but within the break-in-service provisions of the pension plan, The tax court concluded that the potential of a double tax benefit for Chapman in 1976 did exist as of the end of that year. Consequently, the facts were distinguishable from those presented in Foulkes, and the rationale adopted in the Foulkes case was not applicable to permit the taxpayer to take an IRA deduction for 1976.

In Smith, the taxpayer was employed by Sears, Roebuck & Company, which had a savings and profit sharing plan to' which both the employees and the employer made contributions. The employer's contributions for each year were made for the benefit of only those employees who were employed on November 15 of each year. When Smith's employment terminated before November 15, 1975, all of Smith's contributions, including his contributions made in 1975, were returned to him, and all his benefits in the plan were forfeited. Later in 1975, the taxpayer made an' IRA contribution and took the IRA deduction on his 1975 return. The Service denied that deduction, and litigation followed. After a discussion of the meaning of Foulkes, the court noted that the Sears plan was a qualified plan under Internal Revenue Code § 401(a) and therefore the break-in-service rules of Internal Revenue Code § 411(a)(6) may have been incorporated into the plan, particularly the rule that years of service prior to a one-year break in service may not be disregarded in determining the nonforfeitable percentage of a participant's right to employer-derived benefits which would accrue to an employee who was re-employed after such a break in service. Since the taxpayer failed to demonstrate that such a rule would not apply if he became re-employed by Sears after the end of 1976, the potential for a double tax benefit may have existed. So, the taxpayer could not be permitted the IRA deduction for that year.

In Thomsen, Mrs. Thomsen was employed by the town of Vestal, New York, from January 13, 1975, to August 6, 1976. On her behalf, Vestal contributed to the New York State Employees' Retirement System, a qualified pension plan. The plan rules required Mrs. Thomsen to have been employed for five years for her right in its benefits to vest. After she terminated her employment with Vestal on December 31, 1976, she deposited $900 in an IRA, and took a corresponding IRA deduction on her return for 1976. In later reviewing the propriety of' this deduction, the tax court noted that the Foulkes interpretation of the meaning of "active participant" was contrary to the great weight of precedent, but the tax court need not determine whether Foulkes should be followed or rejected. In Foulkes the facts were that the break-in-Service rules prevented the taxpayer from receiving pension credit for

a year in which the taxpayer had also taken an IRA deduction. In Thomsen, on the other hand, the taxpayer had failed to show that she was barred from receiving pension credit for the contested year if she should become re-employed by Vestal. Accordingly, the court found that she was an "active participant" of a qualified pension plan and not entitled to any IRA deduction for that year.

Apparently, appellants and respondent in this case are agreed that at the end of 1978, appellant-husband had no accrued right to any STRS pension benefits. But respondent takes the position that appellant-husband could possibly revive his right to STRS pension benefits based upon 1978 membership time should he become a new employee of an entity which offered STRS membership to new employees and repay to STRS the contributions plus interest which were refunded in 1978.

However, as we have noted above, the record in this appeal contains a memorandum from the State Teachers' Retirement System which states, inter alia: "Mr. Barnathan became a member of State Teachers' Retirement System on September 16, 1974, and remained a member until his election to not be a member in late 1977. ..." Apparently the State Teachers' Retirement System regarded appellant's membership in the system plan to have ceased in 1977 when he filed his election, notwithstanding the fact that appellant's written election to withdraw was not processed by the STRS until some time in 1978. Accordingly, the State Teachers' Retirement System does not regard Mr. Barnathan as having had any membership time during 1978. Since appellant was not a member of the STRS at any time during 1978, there was no basis for either an actual or a potential double tax benefit for that year. Therefore,' we must conclude that appellant was not an "active participant" in a qualified pension plan during 1978.

Accordingly, we must reverse respondent 's action on this appeal.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Herman and Sandra J. Barnathan for refund of personal income tax in the amount of $208.35 for the year 1978, be and the same is hereby reversed.

done at Sacramento, California, this 1st day of February, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr.. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member