79-SBE-179

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MORRIS A. AND MARY ORBACH)

Appearances:

For Appellants: Michael R. Asimow
Attorney at Law

For Respondent: John R. Akin
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 Morris A. and Mary Orbach against a proposed assessment of additional personal income tax in the amount of $1,811.21 for the year 1974.

Morris A. Orbach, hereinafter referred to as appellant, was an employee of The Deutsch Company, Metal Components Division (hereinafter Deutsch). That company required its employees to retire when they reached the age of 65. In accordance with this policy, appellant, retired on August 31, 1973, a Friday, in anticipation of his 65th birthday on September 5, 1973. According to appellant, at the time of retirement "the whole idea sounded good" to him. However, soon thereafter he had second thoughts about retirement and on September 2, 1973, Sunday, he called Mr. Philip E. Holzman, president of Deutsch to request reemployment. Mr. Holzman informed appellant that he could not be reinstated, but that he could be employed as a "new hire", without any pre-existing fringe benefits. On September 4, 1973, Tuesday, appellant was reemployed by Deutsch. He was hired at an hourly wage rate equal to that which he received immediately before he retired, however, he was hired into a position of less responsibility than his previous one, and was treated as a new employee with respect to all fringe benefits.

On January 8, 1974, appellant received a total distribution from the Deutsch pension plan in the amount of $27,753.17. Appellant, together with his wife Mary Orbach, reported the entire distribution on their joint return for 1974 as a gain from the sale of a capital asset held for more than five years. The Franchise Tax Board, respondent, determined that appellant's distribution did not qualify for capital gain treatment and characterized the amounts received as ordinary income. A proposed assessment was issued in accordance therewith for additional personal income tax in the amount of $1,811.21 for the year 1974. In response thereto, appellant filed a protest. After reconsidering the proposed assessment, respondent denied appellant's protest. This timely appeal followed from that action.

The question posed by this appeal is whether the total amounts distributed to appellant from a qualified pension plan were paid on account of a separation from the service of his employer so as to qualify such amounts for special capital gain treatment under section 17503 of the Revenue and Taxation Code.

Subdivision (b) of section 17503 of the Revenue and Taxation Code, during the year in question, provided in pertinent part:

> In the case of an employees' trust described in Section 17501, which is exempt from tax under Section 17631, if the total distributions payable with respect to any employee are paid to the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, . . . the amount of such distribution, to the extent exceeding the amount contributed by the employee ... shall be considered a gain from the sale or exchange of a capital asset held for more than five years ... (Emphasis added.)

Subdivision (b) of section 17503 of the California Revenue and Taxation Code, in relevant part, accords capital gain treatment to certain distributions from a qualified employees' trust (pension plan) when the distribution is occasioned by the employee's death or other separation from the service of his employer. In this respect it is identical t section 402(a)(2) of the Internal Revenue Code of 1954[1] prior to that latter section's amendment by the Employee Retirement Income Security Act of 1974 (Public Law 93 - 406).

It is well established that when identity or even substantial similarity exists between California and federal law, the interpretation and effect given the federal provision are highly persuasive as to the proper application of the state law. (Holmes v. McColgan, 17 Cal. 2d 426, 430 [110 P. 2d 428], cert. den., 314 U.S. 636 [86 L. Ed. 510] (1941); Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P. 2d 893] (1955).)

1/ Section 402(a)(2) is a direct carry-over from section 165(b) of the Internal Revenue Code of 1939, and is identical thereto in all respects relevant to this appeal.

Under that principle, we can seek assistance in interpreting "separation from the service", as that term appears in section 17503 of the Revenue and Taxation Code,, by reviewing the manner that its federal equivalent has been applied. We do that now.

"Separation from the service", within the purview of section 402(a)(2) of the Internal Revenue Code of 1954,2/ has been applied on several occasions. For example, in Estate of Frank B. Fry, 19 T. C. 461 (1952), affd. , 205 F'. 2d 517 (1953), it was found that a seoaration from the service does not occur where there is continued performance of services coupled with continued receipt of compensation. Other applications were made in Internal Revenue Service rulings 56-214, '1956-l Cum. Bull. 196, and 57-l 15, 1957- 1 Cum. Bull. 160, which concluded generally that no separation from the service occurs when there is continued performance of services even if unaccompanied by compensation. And in William S. Bolden, 39 T. C. 829 (1963), it was held that an agreement to stay in the service of an employer in an advisory and consulting capacity, even though the only actual service performed consisted of answering questions about certain customers after the taxpayer had become employed by a second company, precluded finding that a separation from the service had occurred.

These examples demonstrate that a separation from the service does not occur whenever the employment relationship can be said to have continued. Where there is evidence of the continuance of the employmerit relationship, and as the above examples illustrate, this can be found from a variety of indicia, it cannot be concluded that a separation from the service has occurred.

Nonetheless, even with the aforementioned background, the United States. District Court, Eastern District of North Carolina, decided in the case of Barrus v. United States, 23 Am. Fed. Tax R.2d 69-990, that a separation from the service had occurred where

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2/ A separate line of cases and rulings, not relevant to this appeal, exists for separations involving groups of employees. This latter sort of separation occurs as a result of a discontinuation of the employees' trust/pension plan itself, rather than as a result of an individual's action.

1) a taxpayer had retired in earnest, 2) the retirement gave rise to the distribution of funds, in lump sum form, from a qualified employees' trust, and 3) subsequently, as a result of changed circumstances, the taxpayer decided to, and did, return to work.

The subsequent resumption of the employment relationship in that case was not seen as equivalent to a continuation of the employment relationship. As stated by the court,

> [a] separation from the service exists, as in this case, when there is a complete and good faith termination of the employment relationship ...[T]hat [the taxpayer] subsequently renews the employment relationship when the original termination and separation was made in good faith is not sufficient to support a finding that there was not an original, absolute, and good faith termination and separation. (23 Am. Fed. Tax R. 2d, at 69-994.)

Not surprisingly, the above rationale is what appellant urges to be applicable in his case. He argues that he retired in good faith from Deutsch, and is therefore, entitled under Barrus, to be found to have separated from the service as those terms are used in section 17503 of the Revenue and Taxation Code. Respondent, on the other hand, contends first that no break in service occurred in this case, and second that the Barrus case is distinguishable on the facts.

According to respondent the continuity of the employment relationship is shown by several factors. The first of these is said to be the fact that appellant was paid for September 3, 1973, Labor Day, and that since it is Deutsch's policy to pay its employees for a holiday only if they worked the day before and the day after the holiday, this shows that no break in service took place for appellant between Friday, August 31, 1973, and Tuesday, September 4, 1973. However, this contention does not appear to be supported by the record before us. In particular, the record contains a statement

from Philip E. Holzman, president of Deutsch:, speaking to the issue of appellant's holiday pay for September 2, 1973. That statement, while confirming respondent's representation of Deutsch's general policy in regard to holiday pay, nonetheless states that it was not because of that policy that appellant was paid for Labor Day. Rather, appellant was paid for that day only because of Mr. Holzman's personal feeling that it was the equitable thing to do for a "faithful and retired employee who was returning to work because he could not: face up to retirement. " Consequently, the fact that Deutsch paid appellant for Labor Day bears no relation to a continuity of the employment relations hip.

Respondent maintains, nonetheless, that there are other indicia of continuity. Reference is made to.the facts that appellant received the same employee number held previously, that the corporation did not require appellant to complete employment related forms; and that he received the same job classification and pay rate as he had before he retired.

We do not agree. The factors pointed out by respondent in and of themselves may lend some support to the contention that no break in service occurred, but whatever weight they might carry in that regard dissipates in light of the evidence to the contrary. Appellant stated that his retirement was made without intention to continue or return to work, and that only after retiring did he realize he was not prepared for a life without work. This was corroborated in significant part by Mr. Philip Holzman , president of Deutsch. Additionally, evidence was submitted to show that the position acquired by appellant. on Tuesday, September 4, 1973, was one carrying less responsibility than appellant's pre-retirement position. Further, appellant was treated as a new employee with respect to all fringe benefits.

On these bases, therefore, we decline to accept respondent's proposition that appellant's originall retirement from Deutsch on August 31, 1973, was not made in good faith.

Respondent's second contention is that Barrus is distinguishable from appellant's situation on the facts. For instance, the taxpayer in Rarrus severed his connection with his employer for a period of five months. Additionally, the poor health of the taxpayer was cited as a basis for finding

that he completely and in good faith terminated his employment relationship. In contrast, appellant is noted to be in good, health and to have "retired" for only a weekend.

There is no doubt that factually the Barrus case differs from the instant case, but beyond the fact that the cases of any two taxpayers would be expected to differ at least in some respects, there is additional reason why the rather severe factual pattern in Barrus does not prohibit finding a good faith 'termination in another case with less severe facts. In Barrus, as in Fry, and Bolden, supra, the taxpayer involved was a principal stockholder and executive employee of his employer-corporation. An "employee" with that status is in a position to influence any corporate action, including, for example, the facilitation of a bad faith retirement or separation so as to obtain preferred tax treatment of a subsequent distribution from a qualified employees' trust; and later cause the employment relationship to be resumed following the actual getting of the favorable tax treatment. Clearly, an executive employee should face a more stringent test in showing that an employment termination was made in good faith than should a lower echelon employee. This is precisely what is represented by the factual scenario in the Barrus case. In the Barrus case the taxpayer was a principal officer, stockholder, and director of his employer-corporation. Upon his return to the company following his retirement he was elected chairman of the board of directors of the employer-corporation, Barrus Construction Company. Additionally, during the period of his retirement he retained an office, for his personal use, in a building which he owned and which was leased to the corporate employer for use as a corporate headquarters. During this same time he had occasion to render opinions on certain business matters relating to Barrus Construction Company, although it was made clear that final decisions were to be made by personnel of the corporation. Nevertheless, on the basis of his deteriorated health;. on the fact that he had reached 65, the customary age for retirement in business circles; on the fact that as a self-made man he was said to have relished the time he could leave to others the operation of the interests of the corporation; and on the fact that his return was motivated not only by a marked improvement in his health, but also by the improvement

of the business prospects of Barrus Construction Company in a direction specifically tailored to his executive talents, Mr. Barrus was found to have separated his employment relationship in good faith and to have separated from the service under section 402(a)(2) of the Internal Revenue Code of 1954.

The case before us, in contrast, involves a taxpayer who held the position of inventory control clerk,, and who, in our opinion, retired completely and unequivocably before undergoing a psychological crisis of sorts as a result of which he realized that he was not prepared for retirement. That he thereafter sought reinstatement, and in fact, succeeded in being rehired in a "new employee'.' status does not take away from the good faith with which he originally, retired.

On the basis of all the foregoing, it is found that appellant terminated his employment relationship with The Deutsch Company, Metal Products Division in good faith., and consequently, in line with the Barrus case,that he separated from the service of Deutsch under section 17503 of the Revenue and Taxation Code. Pursuant to that section, the lump sum distribution made to appellant from the employees' pension fund as a result of that separation is taxable as a gain from the sale or exchange of a capital asset held for more than five years.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Morris A. and Mary Orbach against a proposed assessment of additional personal income tax in the amount of $1,811.21 for the year 1974, be and the same is hereby reversed.

Done at Sacramento, California, this 11th day of December , 1979, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member