96-SBE-022

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 95A-0400
Kenneth B. and Ilene Bonilla	)	
	)	

Representing the Parties:

For Appellants: Alison Smith Fay, Attorney
Deborah Fabricant, Attorney

For Respondent: Richard Gould, Counsel

Counsel for Board
of Equalization: John S. Butterfield,
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Kenneth B. and Ilene Bonilla against assessment of additional personal income tax in the amount of $180,237 for tax year 1988.

The issue presented in this appeal is whether certain distributions received by appellant-husband from a qualified pension plan are exempt from tax by operation of Internal Revenue Code (IRC) section 105, which has been incorporated by reference in Revenue and Taxation Code section 17131.

Appellant-husband, Kenneth B. Bonilla, M.D., was a participant in the Kenneth B. Bonilla, M.D., Incorporated Amended Defined Benefit Pension Plan (Defined Benefit Plan) and the Kenneth B. Bonilla, M.D., Incorporated Amended Money Purchase Pension Plan (Money Purchase Pension Plan)(collectively, Plans). Each of the Plans was established and intended to constitute a tax-qualified retirement pension plan under IRC section 401(a). Each of the Plans provided for payment of the participant's accrued benefit upon the occurrence of the participant's "permanent disability."

Appellants allege that in 1987, appellant-husband was first diagnosed as possibly suffering from Parkinson's disease. That diagnosis was confirmed in February of 1988. In April of 1988, appellant-husband's doctor advised him that his condition made it unwise to continue in his profession as a thoracic and vascular surgeon.

On May 4, 1988, appellant-husband applied to the Plans for distribution of his accrued benefit, as provided by the terms of the Plans. On June 21, 1988, the Administrative Committee of the Plans, which consisted of appellant-husband, and possibly appellant-wife, directed the Plan's trustees to distribute 95 percent of appellant-husband's accrued benefit in each plan to him on account of "permanent disability."[1]

On July 1, 1988, the total assets held in both Plans totaled $3,850,201.58. On that date, both Plans were terminated and the trustee distributed the following amounts to all the participants in the Plans:

1. Ms. H. Josephine Vasquez $4763.33
2. Ms. Connie Robertson $1928.97
3. Ms. Karen Hubert $1693.70
4. Mrs. Ilene Bonilla $107,961.09
5. Dr. Kenneth Bonilla $2,037,876.49

The remaining balance of the trusts, $1,695,978.00, was returned to the employer, Kenneth B. Bonilla, M.D., Incorporated, and subsequently distributed to appellant-husband as compensation in an uncontested transaction.

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[1]We note that under the provisions of the Plans, as amended, it was not necessary for a participant to be totally disabled in order to qualify as "permanently disabled" and trigger his entitlement to disability distributions from the Plans. Indeed, while appellant-husband could no longer function as a surgeon, he could and did operate a private expert medical testimony business which earned income in 1989, 1990 and 1991. However, the fact that appellant-husband may not have been totally disabled in 1988 does not, by itself, render a payment ineligible for section 105 treatment.

When they filed their tax return for 1988, appellants excluded from their gross income the sum of $1,891,390, which represented 95 percent of the $2,037,876.49 distribution to appellant-husband. Appellants argue that the excluded amount represented the distribution to him on account of his permanent disability as determined by the Executive Committee,[2] and was not includable in gross income under IRC section 105. Respondent disagreed and is attempting to assess additional tax based on inclusion of the disputed amount in appellant's gross income.

IRC section 105 relates to the application of tax to amounts received under accident and health plans. Section 105(a), which sets forth the general rule, provides in part that amounts received through accident or health insurance for sickness are included in gross income to the extent such amounts are attributable to contributions by the employer which were not includable in the gross income of the employee. There are several exceptions to the general rule, including the exception provided in section 105(c), which provides:

> "(c) **Payments Unrelated to Absence From Work**-Gross income does not include amounts referred to in subsection (a) to the extent such amounts - (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work."

By themselves, sections 105(a) and 105(c) would only apply to amounts received through accident and health insurance. However, under section 105(e), amounts received under "an accident or health plan for employees" are treated as amounts received through accident and health insurance. Thus, to be excludable under section 105(c), the amounts must be received either through accident and health insurance or through an accident and health plan for employees. The dispositive question in this case is whether the Plans were accident or health plans for employees.

Appellants argue that the Plans were "dual-purpose" plans, providing both pension and "accident and health" benefits. They point to Resolutions of the Board of Directors of the employer when the Plans were adopted or amended which stated the employer's intention that the Plans serve both as pension plans and as accident and health plans as provided by section 105. They argue that the fact that disability payments may be made from the Plans demonstrates that the Plans "provide for payments of amounts to employees in the event of personal injuries or sickness."

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[2] It appears that the "Executive Committee" was made up of the two appellants.

The question in this case may be resolved by the application of two Treasury Regulations. Treasury Regulation section 1.105-5(a) states in pertinent part:

> "In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness."

Treasury Regulation section 1.401-1(b) provides in pertinent part:

> "A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. . . . A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14)." (emphasis added)

When these two regulations are read together, it is clear that, while the payment of disability benefits would not disqualify a plan for IRC section 401 purposes, the provision in a plan for accident and health benefits would. The appellant has stated, and we agree, that the Plans in question are qualified pension plans under IRC section 401. As such, by definition, they cannot contain accident and health provisions, and therefore, they cannot constitute a "health and accident plan" for purposes of section 105. Since the benefits paid in this case were paid from a qualified pension plan, and not from a health and accident plan, they may not be excluded from income under section 105.

Although we resolve this case based on the nature of the Plans as qualified pension plans under IRC section 401, we note that even if the Plans had been other than qualified pension plans (such as profit-sharing plans or stock bonus plans), we would still find that the payments in question were includable in gross income despite the language inserted in the Plans which purport to ascribe a "dual purpose" to them. There is no provision in the Plans for the provision of medical benefits of any kind, and the only disability benefits are for total and permanent disability. The maximum amount of the disability benefit is limited to the amount of the participant's vested pension account.

We believe that the correct analysis of these types of plans must look beyond the self-serving language grafted onto what are, at their root, garden variety pension or profit sharing plans. In Gordon v. Commissioner (1987) 88 T.C. 630, the United States Tax Court pointed out that a Revenue Ruling dealing with section 105(b), which concerned taxability of distributions from a profit sharing plan for medical expenses, was equally applicable to section 105(c). In applying Revenue Ruling 69-141, 1969-1 C.B. 48, the court stated:

> "(1) Amounts contributed by an employer out of its profits represent deferred compensation for services rendered by the employee and are taxable to him as provided in section 402(a) when actually distributed or made available.
> "(2) The fact that a distribution may be made from a profit-sharing plan in the event of illness or physical loss does not change the character of the distribution from one of deferred compensation to one of accident or health benefits to which section 105(b) or (c) applies.
> "(3) Under a profit-sharing plan, unlike an accident or health plan, the participant becomes entitled to amounts representing his vested interest thereunder regardless of whether he receives reimbursement for medical care expenses under section 105(b) or the kind of physical loss contemplated by section 105(c).
> "(4) The use of the money distributed for medical care under section 105(b) or for physical loss under section 105(c) is no different under the foregoing circumstances than the use thereof for other personal expenses."

In this case, the result of appellant-husband's disability was to vest the entire amount of his pension plan account in him.[3] The only question was how he would choose to receive it. In the absence of any provision in the Plans which would make his eventual receipt of any or all of his pension account dependent on the fact of his disability, we do not believe that the Plans in question qualify as accident and health plans, despite their self-identification. Rather, we believe that under Revenue Ruling 69-141, to qualify as a "health and accident" plan, there must be some insurance element in the Plans. The receipt of benefits must be, to some extent, dependent upon whether the participant suffers a compensable loss. Where, under a profit sharing plan or pension plan, the employee-participant has become entitled to the amounts representing his interest in the plan regardless of whether he incurs medical expenses or suffers an injury, and the amounts distributed from the plan on account of disability

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[3]This provision may be redundant, as appellant-husband may have already qualified for full vesting based on his length of service prior to any finding of disability.

"merely reduces the amount credited to his account that he may ultimately receive", such distributions are taxable. (Rev. Rul. 69-141, supra.)[4]

We further note that the United States Tax Court has recently considered this issue and has determined that to constitute a valid health and accident plan, a plan must compute the amount of the benefit with reference to the nature of the injury. It is not enough to, as appellants' Plans do, leave the amount to the discretion of the trustee with no further guidance. "Rather, 'the instrument or agreement under which the amounts are paid must *itself* provide specificity as to the permanent loss or injury suffered and the corresponding amount of payments to be provided.' Rosen v. United States, supra at 509 (emphasis added)." (Estate of James F. Hall, Jr. v. Commissioner (1996) ¶ 96,093 T.C.M. (RIA).)

In this case, the participant's eventual right to receive his vested pension benefits was not dependent upon a finding of disability. The only question was whether he could receive them prior to his normal retirement date. The disability benefit provided by the Plans was to allow the appellant-husband access to his vested participant account upon disability, rather than at normal retirement age. No specific provisions of the Plans dealt with the payments to be made on account of specific injuries or losses, or the amounts of such payments.

Exclusions from income are a matter of Legislative grace, and as such must be strictly construed. It rests with the Legislature to determine under what circumstances it will allow a taxpayer to receive income tax-free. We are quite convinced that the Legislature did not intend to delegate this authority to a "committee" composed of a taxpayer and his wife, who by declaration have attempted to convert taxable pension benefits to non-taxable distributions, simply by changing the label they seek to attach to the payments. If a taxpayer wishes to provide for tax-free disability payments in the event of his disability, he should purchase disability insurance with after-tax dollars. He cannot cause his wholly owned corporation to deduct contributions to a pension plan, and then unilaterally determine that he may receive the money tax free because he has become disabled.

Accordingly, the action of respondent must be sustained.

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[4]"A revenue ruling, as distinguished from a regulation or administrative decision does not have the force and effect of law. Nevertheless, the rulings do constitute a body of experience and informed judgment to which courts may properly resort for guidance in the interpretation of relevant revenue statutes and regulations." (Watts *v.* United States (9th Cir. 1983) 703 F2d 346, 350, fn.19.) In Gordon, supra, the Tax Court explicitly agreed with the analysis and conclusions in Revenue Ruling 69-141.

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 Kenneth B. and Ilene Bonilla against a proposed assessment of additional personal income tax in the amount of $180,237 for the year 1988 be and the same is hereby sustained.

Done at Sacramento , California, this 4th day of December, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

Brad Sherman, Member

Rex Halverson*, Member

* For Kathleen Connell per Government Code section 7.9.