97-SBE-011

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	
	)	No. 95A-0844
Roy and Phyllis Watts	)	
	)	

Representing the Parties:

For Appellants: Frances G. Pardee, E.A.

For Respondent: Richard Gould, Tax 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[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Roy and Phyllis Watts against a proposed assessment of additional personal income tax in the amounts of $608, $718 and $520 for the years 1991, 1992 and 1993, respectively.

The only issue in this appeal is whether a lump sum distribution from a pension plan which is rolled over into an Individual Retirement Account (IRA), while the recipient is a non-resident of this state, must be added to the recipient's California basis in the IRA when the recipient becomes a resident of this state.

Prior to 1984, appellants were residents of the state of Illinois. During the time they were residents of Illinois, appellants made annual contributions to an IRA. Also prior to 1984, appellant-husband received a lump sum distribution from his employer's qualified pension plan. Pursuant to Internal Revenue Code (IRC) section 402(a)(5), appellant-husband "rolled-over" the lump sum distribution into his IRA. Absent this rollover, the lump sum distribution would have been included in appellant-husband's income in the year he received it, and would have been subject to federal and Illinois income tax. The effect of the rollover was to defer taxation of the pension plan distribution from the year the distribution was received, until the year or years it was distributed to appellant-husband from his IRA.

[1]Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

In 1984, appellants retired to California, and thereafter began to take distributions from the IRA. While appellants apparently do not dispute the taxability of these distributions for federal purposes, they contend herein that the distributions are not subject to California tax.[2]

Revenue and Taxation Code section 17041, subdivision (a), provides for the taxation of the entire taxable income of every resident of this state, and Revenue and Taxation Code section 17501 conforms California law to IRC section 408(d)(1) with regard to the taxation of IRA distributions. Any amount paid or distributed out of an individual retirement plan is to be included in gross income, as provided in IRC section 72. However, to avoid double taxation, IRC section 72 allows a portion of a distribution to be excluded from gross income, to the extent such portion represents the distributee's "investment in the contract." The investment in the contract is the amount of contributions made to the IRA which were not deducted by the taxpayer in the years the contributions were made, and hence were already included in the taxpayer's taxable income in the year the contribution was made. This amount is referred to as the taxpayer's "basis" in his IRA. Just as in other tax contexts, a return of basis is not taxed.

A taxpayer's basis in his IRA for California purposes may be different from his federal basis. This may occur for several reasons. Between 1982 and 1986, California only allowed up to $1500 to be contributed to an IRA and simultaneously deducted from gross income. During those same years, the federal government allowed deductible contributions of up to $2000. As a result, a taxpayer making a $2000 contribution to his IRA would be allowed to exclude $2000 from his income subject to federal tax for that year, but only $1500 of the amount could be excluded from his California income, leaving $500 subject to tax in California in the year the contribution was made. To avoid taxing that $500 again when it was distributed out of the IRA in subsequent years, the taxpayer received a $500 basis in the IRA for California purposes. Hence, if he received a distribution of $2000 from the IRA in a subsequent year, the entire $2000 would be subject to federal tax in the year it was received, but only $1500 would be taxed by California, the balance of the distribution being treated as a return of basis.

In addition, respondent allows taxpayers to treat as basis the amount of "annual contributions" to an IRA (up to a maximum amount of $2000 per year) and the earnings thereon, which were made while the taxpayers were residents of another state. This adjustment would serve to prevent the potential for double taxation should the state of prior residence seek to tax the distribution. The statutory basis for this treatment was former Revenue and Taxation Code section 17530, subdivision(d)(1). (Repealed effective January 1, 1983.) Despite the repeal of former section 17530, respondent has continued to allow these additions to basis.

Respondent's practice of allowing an additional California basis for annual contributions and the earnings thereon, made or accrued while a taxpayer was a resident of another state, provides appellants with their argument in this case. In essence, appellants ask that we require respondent to

[2]The distributions are not subject to Illinois tax, because although the lump sum distribution would have been taxable in Illinois but for the deferral occasioned by the rollover, Illinois does not tax distributions from retirement plans, including IRAs, made to non-residents. (ITA section 301(c)(2).) Thus, there is no danger of double taxation if California taxes the distributions.

extend the treatment it allows for annual contributions made while residents of another state, to all contributions made while a non-resident of California, including rollover pension plan contributions. We decline to do so.

The distribution which appellant-husband received from his employer's pension plan was taxable income. He deferred the tax by rolling it over into his IRA. By moving to California, he escaped taxation by Illinois on the income. Because Illinois does not tax the IRA distributions received by non-residents, the requested basis adjustment is not necessary to protect appellants from double taxation. The California tax assessed on the distribution will be the first time the income in question has been subjected to tax by any state.

As set out above, we are aware of no currently operative statute or regulation which requires respondent to make the basis allowance for contributions to an IRA made while a non-resident. However, the administrative actions of respondent, as the agency charged with administration of the personal income tax law, are entitled to great weight (Mel v. Franchise Tax Board (1981) 119 Cal.App.3d 898, 911, fn.15 [174 Cal.Rptr. 269]; Coca-Cola Co. v. State Board of Equalization (1945) 25 Cal.2d 918, 921 [156 P.2d 1]), and this Board has been reluctant to substitute its own judgment unless it is persuaded that respondent's practice is clearly erroneous (see, e.g., Appeal of Estate of Philip Rosenberg, et al., Cal. St. Bd. of Equal., Aug. 19, 1975, modified Feb. 2, 1976). Absent a conflict with a statute or regulation we will not disturb respondent's action, nor will we require that respondent expand its administrative practice beyond the parameters established by it.[3]

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[3]We do note, however, that with the recent passage of 4 U.S.C. section 114, all states are now prohibited from attempting to tax the distributions from IRAs made to residents of another state. That being the case, the potential for double taxation should California tax the IRA distributions no longer exists, thus the need for respondent's practice of allowing basis adjustments in order to protect against the potential of double taxation has also been obviated. However, we acknowledge that respondent may have other reasons for its practice.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Roy and Phyllis Watts against a proposed assessment of additional personal income tax in the amounts of $608, $718 and $520 for the years 1991, 1992 and 1993, respectively, be and the same is hereby affirmed.

Done at Sacramento, California, this 8th day of May, 1997, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Klehs, Mr. Andal, Mr. Halverson and Mr. Chiang present.

Ernest J. Dronenburg, Jr., Chairman

Johan Klehs, Member

Dean F. Andal, Member

Rex Halverson*, Member

John Chiang**, Member

*For Kathleen Connell, per Government Code section 7.9.
**Acting Member, 4th District.