CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 412

January 16, 1979

TAXATION OF CALIFORNIA PERS BENEFITS

Syllabus:

Issue 1:

Taxation of insurance benefits paid pursuant to § 21405 of the Government Code (G.C.).

Facts:

H, a male employee of the State of California, is 40 years old and has more than 10 years of state service. H dies while in state service. H earned $24,000 in wages during the year preceding his death. On H's death, his wife (W) is paid $17,000 in "insurance benefits" pursuant to G.C. § 21405. /1

§§21400 -- 21406 of the G.C. were enacted to provide group term life insurance benefits for employees of the state of California. The insurance benefits are funded entirely by contributions and transfers made by the state. The insurance contributions are by law maintained in a separate fund from other pension and retirement funds.

Under the group term insurance provisions, if a state employee dies while in state service under specified conditions, his beneficiary or estate is entitled to receive insurance benefits. The insurance benefits under G.C. § 21405 consist of the sum of $5,000 and an amount equal to 50 percent of the annual compensation of a deceased employee for the 12 months period immediately preceding the employee's death. If, at the date of the employee's death, he or she was eligible for service retirement (G.C. § 20951 provides that a member is eligible for service retirement if over age 50 with more than 5 years service), the beneficiary or estate is not eligible for the portion of the insurance benefit equivalent to 50% of 12 months salary.

Question:

What portion, if any, of the $17,000 received by W is includable in gross income?

/1 5,000 under subdivision (a) plus $12,000 under subdivision (b).

Decision:

No portion is includable in W's gross income as entire amount received constitutes life insurance proceeds. See discussion below.

Discussion:

Revenue and Taxation Code (R & TC) § 17131 provides for the exclusion from gross income of amounts received under a contract of life insurance if such amounts are paid by reason of the death of the insured (life insurance). R & TC § 17132 excludes from gross income amounts received by the beneficiary or estate of the employee, if such amounts are paid by or on behalf of an employer, and are paid by reason of the death of the employee (death benefit). The death benefit exclusion is limited to $5,000 and does not extend to any amounts to which the deceased employee possessed a nonforfeitable right to receive the amounts while living.

Under G.C. § 24105, an employee does not possess a nonforfeitable right to any benefit while living. The benefits under G.C. § 21405 are payable only upon the death of the employee; thus the payments are either life insurance proceeds or they are employee death benefits.

It is well established that a contract of life insurance need not be in the form of a standard life insurance contract in order for the proceeds to qualify for the life insurance exclusion. (Mary Tighe, 33 T.C. 557, 564 (1959); Estate of Benton Louis Snyder, 4 TCM 957 (1945).) Although the contract need not be in the traditional form, there must be a binding arrangement involving risk shifting and risk distributing. (Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Estate of Barr, 104 Cal.App.2d 506, 508 -- 509 (1951).)

Under the plan in question, the state on behalf of its employees contributes to a fund out of which definite benefits are to be paid upon the death of an employee. Thus, the risk shifting requirement of an insurance arrangement is satisfied because, to the extent of the prescribed benefits, the economic risk which could arise from the employee's death is shifted from his or her survivors to the fund. The element of risk distribution is satisfied because the whole of the state employee work force is taken into consideration in arriving at the contributions required by the state to fund the program. Since the arrangement satisfies the traditional elements of risk shifting and risk distribution, it constitutes a life insurance arrangement. (See Ross v. Odom, 401 Fed.2d 464 (5th Cir. 1968), Shaw v. Board of Administration, 109 Cal.App.2d 770, 774 (1952).)

In the factual situation presented, W would not be required to include in taxable income any portion of the benefits received under G.C. § 21405(a) and (b) by virtue of the life insurance exclusion provided by R & TC § 17131.

Issue 2:

Taxation on basic death benefits paid pursuant to G.C. §§ 21360 and 21361.

Facts:

H, a male employee of the State of California and a miscellaneous member of PERS, is 55 years old and has more than 10 years of state service. H dies in 1977 in state service before retirement. During his period of state service H made mandatory employee contributions to PERS totaling $20,000. The total amount of accumulated employee contributions, including credited interest, in his account is $24,000. During the period preceding H's death his salary was $24,000 a year. On H's death his wife (W), also age 55, in addition to the $5,000 group term life insurance (see Issue 1), received $36,000 in 1978 pursuant to G.C. § 21361. /2

G.C. §§ 21360 and 21361 provide that if a miscellaneous member of PERS dies while employed by the state, a "basic death benefit" is payable to the deceased member's estate or beneficiaries. The basic death benefit is equal to the employee's "accumulated contributions" to PERS (actual contributions plus interest credited thereon -- G.C. § 20031). In addition to the return of "accumulated contributions," an employee who is eligible for "service retirement" (over age 50 with more than 5 years of state service) is eligible for a basic death benefit equal to 1/12 of the employee's annual earnable compensation for the 12 months preceding his or her death multiplied by the number of years completed current service to the member, but not to exceed one-half of such compensation. Persons eligible to receive the additional basic death benefit equal to one-half year's salary are not eligible to receive the equivalent insurance benefit under G.C. § 21405(b) (See discussion under Issue 1).

Question:

Is any part of the basic death benefit of $36,000 received by W pursuant to G.C. §§ 21360 and 21361 includable in W's gross income?

Decision:

Yes, $11,000 of benefit payments is subject to inclusion in W's 1978 gross income. See discussion below.

/2 $24,000 under subdivision (a) based on H's accumulated contributions and $12,000 under subdivision (b) based on H's salary for the preceding 12 months.

Discussion:

As set forth in the discussion under Issue 1, R & TC § 17131 provides for an exclusion from gross income of amounts paid under a life insurance contract by reason of the death of the insured. R & TC § 17132 provides for an exclusion from gross income of up to $5,000 for amounts paid to the beneficiary or estate of a deceased employee by or on behalf of his or her employer, if such amounts are paid solely by reason of the death of the employee. A distribution or payment does not qualify for the limited death benefit exclusion if the employee possessed, immediately before his or her death, a nonforfeitable right to receive the amount of the payment while living.

With respect to the benefit which consists of the "accumulated contributions" to PERS, an employee is entitled to recover such contributions on demand after termination of employment with the state (G.C. § 20652). As such arrangement has none of the traditional risk shifting and risk distribution elements of life insurance and the employee possessed a nonforfeitable right to his or her accumulated contribution while living, the portion of the basic death benefit equal to the employee's "accumulated contributions" does not qualify for total or partial exclusion as life insurance proceeds under R & TC § 17131 or as death benefits under R & TC § 17132. The excess of the accumulated contributions distribution over the employee's actual contributions (the accumulated interest) is subject to tax as ordinary income by the recipient beneficiaries or estate.

The additional basic death benefit paid the survivors of a member employee eligible for service retirement (the portion of benefit based upon years of service and employee compensation) is subject to different considerations. The arrangement differs initially in that the employee does not have a nonforfeitable right to the benefit while living. The benefit is paid by PERS solely by reason of the death of the employee. Also, the benefit is paid out of the general retirement fund rather than any separate insurance fund.

A review of the plan indicates that the arrangement has all of the attributes of a retirement death benefit plan and none of the essential elements, as previously discussed, of a life insurance arrangement (Essenfeld v. Commissioner, 311 Fed.2d 208 (2 Cir. 1962).) The benefit does, however, come within the definition of an employee death benefit under R & TC § 17132. Thus, under § 17132 the basic death benefit based on salary would be subject to exclusion from gross income up to$5,000.

In the factual situation presented, W would report the basic death benefits in the following manner:

Total death benefits received by W:

Accumulated contributions (G.C. § 25631(a))	$24,000	
Benefit equal to 6 months pay (G.C. § 25631(b))	12,000	
Total		$36,000
Less:		
Return of employee's contributions	$20,000	
Employer death benefit exclusion (R & TC § 17132)	5,000	
Total		(25,000)
Portion of benefit includable in gross income		$11,000

Issue 3:

Taxation of monthly survivor allowance paid pursuant to G.C. § 21365.5 (1957 Survivor Benefit).

Facts:

The same facts as in Issue 2, except W's elects to receive a monthly allowance of $500 under G.C. § 21365.5 in lieu of the basic death benefit payable under G.C. § 21361. W received 12 payments, or $6,000 in 1978 pursuant to G.C. § 21365.5. At H's death W's total expected return under the arrangement is $153,000. The present value of the monthly allowance at his death is approximately $71,500.

G.C. § 21365.5 provides that upon the death of a miscellaneous state employee who is eligible for service retirement (over age 50 with 5 or more years of service) his or her surviving spouse may elect to receive a monthly allowance in lieu of the basic death benefit payable pursuant to G.C. § 21361(a) and (b). The allowance is equal to one-half the unmodified retirement allowance which the deceased employee could have elected to receive if the employee had retired on the date of death. Such allowance continues to the surviving spouse until death or remarriage. If either death or remarriage occurs prior to recovery of an amount equal to the basic death benefit, an amount equal to the unrecovered balance is payable in lump sum to the spouse, the surviving children or the estate of either.

Question:

What portion of the $6,000 received by W in 1978 pursuant to G.C. § 21365.5 is subject to tax?

Decision:

$5,020 -- See discussion.

Discussion:

As determined in the discussion under Issue 2, only the portion of the unvested basic death benefit (i.e., 6 months pay) which is payable by the employer after death qualifies as an employee death benefit subject to partial exclusion under R & TC § 17132. (See Cal. Admin. Code Reg. §§ 17131 -- 17132(b)(2)(3) and Rev. Rul. 59-255, 59-2 C.B. 36.) R & TC § 17132 (b)(4) provides that where a death benefit is payable as an annuity, the amount of the death benefit subject to exclusion shall be treated as additional consideration paid by the employee.

The computation of W's reportable income in the situation presented herein would be as follows:

H's direct contributions to PERS		$20,000
Present value of annuity	$71,500	
Less: Accumulated contributions	24,000	
Value of annuity which was forfeitable prior to death	$47,500	
Maximum § 17132 exclusion (the lesser of $47,500 or $5,000)		5,000
W's costs basis in annuity		$25,000

Exclusion Ratio:

Cost basis 25,000 Divided by Expected Return $153,000 = 16,340%.

Amount Includable in 1978 Income:

Amount received ($500 x 12)	$ 6,000
Excluded portion ($6,000 x 16.340%)	980
Taxable portion	$ 5,020

The R & TC § 17104 three-year recovery rule is not applicable to the payments as W will not receive in excess of $25,000 in three years.

The same general principle of taxation is applicable with respect to the alternative Option 2 Settlement paid pursuant to G.C. § 21365.6.

Issue 4:

Treatment of survivors' benefits paid pursuant to G.C. §§ 21380 -- 21390 (1959 Survivor Allowance).

Facts:

H, a male 55 years of age, is an employee of the State of California and a member of PERS. H is not covered by Social Security coverage. As a substitute for Social Security survivor coverage, H elected to pay $2 per month to PERS so that in the event of his death before retirement his eligible survivor(s) would receive the allowance provided by G.C. §§ 21382 and 21382.2. /3

H's election to contribute $2 a month to the 1959 Survivor Benefit Plan is irrevocable regardless of whether or not H has eligible beneficiaries. Amounts contributed to the plan are not recoverable by the employee and can only be used to pay the survivor allowance.

H dies in 1978 after having paid $580 into the 1959 Survivor Benefit Fund. H is survived by two male children, A, age 14 and B, age 15.

Under the provisions of G.C. §§ 21382 and 21382.2, the children are entitled to a monthly benefit of $225 each until they reach age 18 (22 if full-time students). During the remainder of 1978, H's children received 10 benefit payments totaling $4,500 ($225 x 2 x 10).

Question:

What portion, if any, of the 1959 survivor benefit allowance payments of $4,500 are includable in A's and B's gross income in 1978?

/3 When the 1959 Survivor Benefit Plan was formulated it was intended that it would be funded by one-half by employer and one-half by employee contributions. If contributions are inadequate to fund the plan, the state is required to make additional contributions sufficient to pay current benefits. Due to the inherent characteristics of the employee work force electing to participate in the program, the state was initially required to make additional contributions to cover benefit payments. Currently, employee contributions exceed benefits being paid survivors of miscellaneous state employees. PERS is required by G.C. § 20230.5 to maintain a separate record of all funds contributed to the 1959 Survivor Benefit Fund.

Decision:

None -- See discussion.

Discussion:

Because of the similarity between benefits provided under the 1959 Survivor Benefit Program and Social Security Survivor Program, consideration has been given to whether such benefits are excludable from gross income as are death benefits paid under the Social Security Act. (See Cal. Admin. Code, Tit. 18, Reg. 17071(j)(2); Rev. Rul. 70-217, 1970-1 C.B. 13.) The Internal Revenue Service has held, however, that the similarity between benefits provided by the social security system of the United States and the benefits provided by the social security system of any foreign country is not a valid basis for excluding the benefits paid by a foreign nation from gross income. (Rev. Rul. 66-34, 1966-1 C.B. 22.) Applying the same reasoning, benefits paid by a local state government are not excludable from gross income even though they are of the same general character as benefits paid under the Social Security Act.

As the state survivor benefits do not qualify as exempt social security payments, consideration must be given as to whether such benefits qualify for exemption as life insurance proceeds or employee death benefits. The normal elements considered in determining whether an arrangement is life insurance are set forth in the discussion under Issue 1. The general holding in the federal courts has been that indefinite employee survivor death benefits paid by a state or local government do not constitute life insurance proceeds. (See Davis v. U.S., 323 Fed. Supp. 858 (1971); Laura v. Lilly, 45 T.C. 168 (1965); Marian Essenfeld v. Commissioner, 311 Fed.2d 203 (1962).) In a number of these decisions it was found that, absent a definite benefit payable in any event upon the death of the employee, there is no shifting of risks in any meaningful sense and, therefore such a plan does not constitute a life insurance arrangement. As the 1959 Survivor Benefit Plan is not payable unless the employee dies with eligible survivor(s), under the cited federal cases the plan would not constitute life insurance program. The facts herein are distinguished from the decision of the U.S. Court of Appeals, Fifth Circuit, in Ross v. Odom, 401 Fed.2d 464 (CA-5, 1968), wherein the court found that proceeds from a self-insured state death benefit program which provided a definite benefit constituted exempt life insurance proceeds.

Although the 1959 Survivor Benefit Plan lacks the characteristics of a life insurance arrangement, the benefit is payable solely on account of the employee's death by or on behalf of the employer (State of California). Immediately prior to death, the employee does not possess a nonforfeitable right to any part of the proceeds. The benefit therefore qualifies for the partial $5,000 employee death benefit exclusion allowed under R & TC § 17132. Cal. Admin. Code, Tit. 18, Reg. §§ 17131 -- 17132(b)(3) provides that the exclusion shall be apportioned among the beneficiaries in the proportion that the present value of each benefit bears to the total value of all benefits. §§ 17131 -- 17132(b)(5) references to federal estate tax regulations and related Rev. Proc. 71-1, 1971-1 C.B. 34, for actuarial tables to be used in determining present value of benefits. Where survivor benefits are sufficiently akin to survivors' benefits paid under the Civil Service Retirement Act, such benefits are held to constitute an annuity, (Laura v. Lilly, supra.) In computing the expected return annually, factors of the annuity, viz., marriage or loss of student status will not be considered. (Rul. 68-293, 1968-1 C.B. 43; Rev. Rul 70-490, 1970-2 C.B. 11; Rev. Rul. 72-80, 1972-1 C.B. 55.) Where the death benefits are treated as an annuity, each beneficiary's share of the $5,000 exclusion is treated as part of the deceased employee's cost of the annuity and prorated over the term of the annuity. (Cal. Admin. Code Tit. 18, Reg. §§ 17101 -- 17112(h)(E)(2).) If the expected aggregate annuity payments for the first three years however, exceed the employee's cost, all payments are excluded from gross income until an amount equal to such cost has been recovered. (Rev. Rul. 58-153, 1958-1 C.B. 43.)

In the factual case presented, A and B would be taxed for the year 1978 as follows:

PRESENT VALUE OF ALLOWANCE
Interest at 6.0 Percent

	Amounts	Percentage of Total
A - $2,700 x 6.1839 x 1.0272* *(monthly payment factor)	$17,151	53.33
B - $2,700 x 5.5597 x 1.0272 *(monthly payment factor)	15,011	46.67
Total	$32,162	100.00%

Investment in Contract

Employee contributions	$ 580
Death benefit exclusion (Maximum $5,000)	5,000
Total	$5,580

§§ 17101 -- 17112(m)(D) provides that if there are multiple beneficiaries and R & TC § 17104 (three-year rule) is applicable, all amounts received by the beneficiaries are excludable from their gross income until the aggregate amount has been recovered. (Rev. Rul. 72-555, 72-2 C.B. 44.)

In the factual situation, A and B together are scheduled to receive $16,200 ($450 x 36) in three years. As this amount exceeds the investment in the contract of $5,580, all of the allowance received by A and B in 1978 is excluded from gross income. If the total contributions are not recoverable within three years, A and B would be required to apportion the investment in the contract between them based on the present value of each annuity to the total. Each individual beneficiary would then compute his own exclusion ratio based upon his expected recovery under the contract.

Issue 5:

Taxation of annuity benefits received by the survivor of a retired state employee.

Facts:

W, a female, retired from state service on June 30, 1977, at age 60. At the date of her retirement W was married to H, age 61. W was not covered by Social Security while employed by the state. At the date of her retirement, W is entitled to an unmodified monthly allowance for life of $780.00. W desires to provide some added security for H and elects to take Retirement Option 3 wherein, in exchange for a modification reduction of$15.99 a month H, on W's death, will receive a monthly benefit for his life of $187.01 (unmodified allowance of $780.00 x 1/2 = $390.00 - $15.99 = modified allowance of $374.01 x 1/2 =$187.01). Under G.C. § 21263.4, H is also eligible for a survivor continuance benefit upon W's death in an amount equal to 1/2 of W's unmodified allowance of $780.00 ($390.00). W's contribution to PERS totaled $30,000 and the accumulated interest on such contributions totaled $6,000. After receiving payments of $764.01 ($780.00 -- 15.99) for six months, W died on December 31, 1977. H began receiving monthly payments in January of 1978 in the amount of $577.01 ($390.00 survivor continuance plus $187.01 option benefit). H thus received a total of $6,924.12 in benefit payments under the contract during the year 1978.

Question:

What portion of the $6,924.12 in benefit payment received by H in 1978 is includable in his gross income?

Decision:

$6,005.29 -- See discussion.

Discussion:

The rules for the treatment of annuities are set forth in R & TC §§ 17101 -- 17112. Annuities under these provisions are specifically excluded from the definition of "carryover basis property" by R & TC § 18047(b)(2)(c). §§ 17101 -- 17112 provide that as of the annuity starting date, the deceased employee's investment in the annuity shall be determined. The return of the investment in the annuity so determined, if not recoverable in three years, is to be prorated over the term of the annuity. This proration is accomplished by the means of an exclusion ratio which is computed by dividing the employee's cost investment by the total expected return under the contract as of the annuity starting date. Under §§ 17101 -- 17112.7(b)(1)(c)(i), each separate program of the employer consisting of interrelated contributions and benefits shall be considered as a single contract. Definitely determinable retirement benefits are an example of a separate program of interrelated contributions and benefits. (Reg. §§ 17101 -- 17112.7(b)(1)(c)(ii).)

In the case in question the amount of the investment in the contract as of the annuity starting date is $30,000. This amount is equal to W's actual contributions and does not include the $6,000 in credited interest on the contributions which was not subjected to tax when earned. Pursuant to Reg. §§ 17101 -- 17112.7(b)(1)(c), the survivor continuance and option benefits provided by the state and the employee's contributions are to be considered as one program of interrelated contributions and benefits (See Rev. Rul. 67-179, 1967-1 C.B. 17.) Thus, in computing the expected return, the aggregate amount of compound benefit is taken into consideration. The expected recovery would be computed as follows:

Multiple from Table II (female age 60; male age 61)	25.7
Multiple from Table I (female age 60)	21.7
Difference (multiple applicable to H)	4.0
H's expected return (577.01 x 12 x 4.0)	$ 27,696
W's expected return (764.01 x 12 x 21.7)	198,297
Total expected return of H and W	$225,993

As the expected return of $27,5047,504 (764.01 x 12 x 3) in the first three years, commencing with W's retirement date, is less than her investment in the contract ($30,000), a pro rata portion of each payment is subject to exclusion from income. For the year 1978, H would exclude 13.27 percent ($30,000/225,993) of the payments received, or $918.83 ($6,924.12 x 13.27%) from income. The balance of the payments received or $6,005.29 would be includable in H's gross income.

In the more typical situation, the recovery in the first three years will exceed the investment in the contract and the three-year exclusion rule discussed in Issue 4 will apply.

This memorandum takes into consideration recent changes in the Government Code and the Revenue and Taxation Code with respect to the taxation of benefits paid survivors of state employees. Legal Memorandum 454 which is based upon prior law, is withdrawn.