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**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 19014209  
A. ANTONIO AND )  
M. ANTONIO )  
\_\_\_\_\_ )

**OPINION**

Representing the Parties:

For Appellants: Yuly L. Snapp, Enrolled Agent

For Respondent: David Hunter, Tax Counsel IV

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, A. Antonio and M. Antonio (appellants) appeal actions by Franchise Tax Board (respondent) proposing additional tax of \$5,561.10, plus interest, for the 2013 tax year; additional tax of \$1,199.23, plus interest, for the 2014 tax year; and additional tax of \$1,217.85, plus interest, for the 2015 tax year.<sup>1</sup>

Appellants waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

**ISSUE**

Whether respondent’s proposed assessments for the 2013, 2014, and 2015 tax years related to early distributions from appellant-husband’s military retirement pay (MRP) were reasonable and rational and, if so, whether appellants have established error in the proposed assessments.

<sup>1</sup> Appellants’ brief indicates that they are appealing the full amount of the 2013 proposed assessment, which includes additional tax based on the following four audit items: (1) disallowed personal property rental deduction; (2) disallowed mortgage interest; (3) unreported income; and (4) additional tax on an early retirement distribution. However, appellants do not provide specific contentions regarding the first three audit issues and we find no apparent grounds for tax relief under the facts. Therefore, we will not discuss these three audit issues in our opinion.

FACTUAL FINDINGS

1. Appellant-husband is a United States Air Force veteran. In 2013, when appellant-husband was 52 years of age, he received MRP from Defense Finance and Accounting Service (DFAS). Appellant-husband also received MRP in 2014 and 2015. DFAS issued appellant-husband Forms 1099-R for each tax year at issue and reported Distribution Code 7 in block 7.
2. Appellants filed California Resident Income Tax Returns (Forms 540) for the 2013, 2014, and 2015 tax years. Appellants reported the MRP amounts on Schedule CA, California Adjustments – Residents.
3. Respondent audited appellants' 2013, 2014, and 2015 returns and determined that appellants failed to apply California's 2.5 percent early distribution tax to the MRP reported on their 2013, 2014, and 2015 California returns.
4. Respondent informed appellants that it was reviewing whether the early distributions that they reported on their 2013, 2014, and 2015 returns were subject to tax and requested that they provide an explanation, supporting documents, or corrected Forms 1099-R to support their position.
5. After appellants did not respond to respondent, respondent issued Notices of Proposed Assessments (NPAs) for each tax year at issue. The NPAs proposed a tax for "Early Distribution IRA (Account)" in the amounts of \$1,181.10, \$1,199.23, and \$1,217.85 for 2013, 2014, and 2015, respectively.
6. Appellants protested the NPAs, contending that Forms 1099-R reported Distribution Code 7, and MRP is not subject to additional tax for an early distribution. In another letter to respondent dated March 16, 2018, appellants' representative contended that appellant-husband's MRP qualifies for an income exclusion under Internal Revenue Code (IRC) section 72.
7. In a letter to appellants, respondent acknowledged receiving appellant's protest letter, and indicated that the MRP appellant-husband received during the tax years at issue constitute early distributions from a qualified retirement plan, because he received them prior to reaching the age of 59 ½, and they are subject to a 2.5 percent early distribution tax. Respondent requested appellants to substantiate that appellant-husband meets the qualified reservist exception set forth in IRC section 72(t)(2)(G).

8. After receiving no response from appellants, respondent issued a Notice of Action for each tax year at issue, affirming the NPAs.
9. This timely appeal followed.

### DISCUSSION

Respondent has the initial burden of showing that its action is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Once its burden is satisfied, respondent's determination is presumed to be correct, and the taxpayers have the burden of proving error. (*Todd v. McColgan, supra*, 89 Cal.App.2d at p. 514; *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) Unsupported assertions are insufficient to satisfy taxpayers' burden of proof. (*Appeal of Magidow, supra*.)<sup>2</sup>

R&TC section 17041(a) imposes a tax "upon the entire taxable income of every resident of this state." R&TC section 17071 incorporates IRC section 61, which defines "gross income" as "all income from whatever source derived," including annuity and pension income. (IRC, § 61(a)(9), (11).) Generally, a distribution from a qualified retirement plan or an individual retirement account (IRA) is included in income for the year of distribution. (IRC, §§ 402(a), 408(d).)<sup>3</sup>

An early distribution from a qualified retirement plan is governed by IRC section 72. IRC section 72(t)(1) provides that if a taxpayer receives an early distribution from a qualified retirement plan, as described in IRC section 4974(c), the early distribution is subject to a 10 percent tax (in addition to the income tax otherwise imposed), if, among other things, the taxpayer received the distribution before the age of 59 ½. (IRC, § 72(t)(2)(A)(i).) R&TC section 17085(c)(1) adopts IRC section 72(t) for California tax purposes, but reduces the rate of the early distribution tax from 10 percent to 2.5 percent. IRC section 4974(c) defines a qualified retirement plan as any of the following: (1) a plan described in IRC section 401(a), including a

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<sup>2</sup> Appellant-husband indicates in his letter to his representative that he received an "Early Distribution 10% penalty" from the IRS. Respondent refers to this comment in its brief without confirming that the IRS did in fact assess the 10 percent early distribution tax. If respondent proposed the assessments based on a federal determination, then the taxpayers have the burden to state wherein it is erroneous. (R&TC, § 18622(a).) However, because respondent does not allege, and the evidence does not indicate, that the proposed assessments are based on a federal determination or that the IRS did impose a 10 percent additional tax for early distribution on the MRP incomes in question, respondent has the initial burden.

<sup>3</sup> California conforms to IRC sections 402(a) and 408(d), but modifies IRC section 408(d) with respect to basis, which is not at issue in this appeal. (R&TC, §§ 17501, 17507(b).)

trust exempt from tax under IRC section 501(a); (2) an annuity plan described in IRC section 403(a); (3) an annuity contract described in IRC section 403(b); (4) an individual retirement account described in IRC section 408(a); or (5) an individual retirement annuity described in IRC section 408(b).

Here, it is undisputed that appellant-husband received taxable MRP income during each of the tax years at issue prior to attaining the age of 59 ½. The only issue in this appeal is whether the MRP at issue is subject to California's 2.5 percent early distribution tax. Respondent has not shown, nor does the evidence indicate, that the MRP at issue is an early distribution from a qualified retirement plan pursuant to IRC section 4974, or that the MRP was merely an early retirement distribution. Respondent has proposed the 2.5 percent early distribution tax for each of the tax years at issue without first establishing that IRC section 72(t) and R&TC section 17085(c)(1) apply to the MRP at issue in this appeal.

Respondent argues that its proposed assessments are proper because IRC section 72(t) does not provide an express exception to the early distribution tax for MRP. Citing IRC section 72(t)(2)(G), respondent states, "While certain retirement plan distributions, known as Qualified Reservist Distributions qualify for an exception under IRC section 72(t), Appellant does not meet these requirements." Respondent points to Distribution Code 7 on appellant-husband's Form 1099-R as an indication that appellant-husband received an early distribution from his military retirement account. However, according to IRS Publication, Instructions for Forms 1099-R and 5498, Distribution Code 7 is considered a "normal distribution," meaning that the taxpayer was at least 59 ½ years of age when he or she received a retirement distribution. Alternatively, if no other Distribution Code description applies, the publication clarifies that the default is to use Code 7.<sup>4</sup> Nothing in the IRS's description of Distribution Code 7 indicates that appellant-husband's distribution is from a qualified retirement plan as described in IRC section 4974. Rather, it appears that Distribution Codes 1 and 2 would indicate an early

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<sup>4</sup>"Use Code 7: (a) for a normal distribution from a plan, including a traditional IRA, section 401(k), or section 403(b) plan, if the employee/taxpayer is at least age 59½, (b) for a Roth IRA conversion if the participant is at least age 59½, and (c) to report a distribution from a life insurance, annuity, or endowment contract and for reporting income from a failed life insurance contract under sections 7702(g) and (h). See Rev. Proc. 2008-42, 2008-29 I.R.B. 160, available at [www.irs.gov/irb/2008-29\\_IRB/ar19.html](http://www.irs.gov/irb/2008-29_IRB/ar19.html). Generally, use Code 7 if no other code applies. Do not use Code 7 for a Roth IRA." (Instructions for Forms 1099-R and 5498 (2013), <<https://www.irs.gov/pub/irs-prior/i1099r--2013.pdf>>.)


distribution.<sup>5</sup> Although the distribution codes are not necessarily controlling, respondent has not provided any other legal authority to support its position. Respondent therefore fails to meet its burden that its proposed assessment of additional tax pursuant to IRC section 72(t) for each of the tax years at issue was reasonable and rational, and thus, there is no need to discuss whether appellants established error in the proposed assessments. Accordingly, we reverse respondent's proposed assessment.

### HOLDING

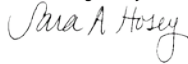
Respondent's proposed assessments of additional tax related to the MRP income were not reasonable and rational.

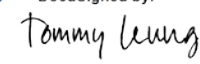
### DISPOSITION

Respondent's proposed assessments are to be recomputed to take into account that the MRP income is not subject to the additional tax for early distribution. In any other respects, respondent's actions are sustained.

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 Andrea L.H. Long  
 Administrative Law Judge

We concur:

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 Sara A. Hosey  
 Administrative Law Judge

DocuSigned by:  
  
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 Tommy Leung  
 Administrative Law Judge

Date Issued: 3/27/2020

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<sup>5</sup> Distribution Code 1 is generally used for an early distribution with no known exceptions and Distribution 2 is generally used for an early distribution and an exception applies. (Instructions for Forms 1099-R and 5498 (2013), *supra*.)