ESTATE PLANNING FOR THE COMMUNITY PROPERTY INTERESTS IN IRAs: ROUND 2[1]

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Background

The winter 1999 issue of the Practical Tax Lawyer included an article that discussed the estate planning issues presented when a couple who resides in a community property state has a significant portion of their assets held inside IRAs. The article suggested that:

- When an IRA account owner (hereinafter referred to as "Account Owner") resides in a community property state, the spouse of the Account Owner ("Spouse") may have a community property interest in the IRA (including a Rollover IRA) to the extent the existence of that interest is consistent with state law.

- The reclassification of an IRA as community property is not considered a taxable distribution for purposes of the Internal Revenue Code.

- Upon the death of Account Owner or Spouse, Spouse's community property interest in the IRA may be transferred by direct trustee to trustee transfer to an IRA that has been established in Spouse's name and classified as Spouse's individual property, without subjecting the amounts being transferred to income taxation.

The article also indicated that a private letter ruling request had been submitted by the author to the IRS in an effort to confirm these opinions. Because the ruling request was submitted on behalf of a Wisconsin resident, it dealt with a Spouse's "marital" property interest, which is analogous to a community property interest for these purposes. Unfortunately, the Service declined to respond to that ruling request, asserting the request involved a "hypothetical situation" until the death of either Account Owner or Spouse.

In light of the IRS' position, a new ruling request was submitted. The new ruling request asked whether a married person residing in Wisconsin could transfer her marital (i.e., community) property interest in an IRA established in the name of her husband (the "Original IRA") by a direct trustee to trustee transfer to an IRA established in her name and classified as her individual property by a marital property agreement (the "Spousal IRA") prior to the death of either Account Owner or Spouse. The new ruling request indicated that actual distribution of IRA funds would not be made at the time of the transfer to either to the Account Owner or to the Spouse. The new ruling request also asked whether minimum distributions from the Spousal IRA could be taken based on the joint life expectancy of the Spouse and her oldest designated beneficiary, subject to the minimum distribution incidental benefit rule.

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[1] This article is current as of 1999. Please contact Willms, S.C. for current information on this topic.

IRS' Response

The IRS responded to the new ruling request by issuing Private Letter Ruling 199937055 (June 24, 1999). The Ruling confirmed that I.R.C. § 408(g) does not abrogate any substantive rights under state law. Therefore, a Spouse may have a community property interest in an IRA to the extent the existence of that interest is consistent with state law. Furthermore, the Service ruled that the reclassification of an IRA as marital (i.e., community) property pursuant to a property agreement is not considered a taxable distribution for purposes of § 408(d)(1). However, the Service also ruled that the transfer of a Spouse's marital property interest in the IRA to an IRA established in the Spouse's own name would constitute a taxable distribution for purposes of §408(d)(1). In reaching that decision, the IRS stated:

> The owner of an IRA account is deemed to be the individual in whose name the account was established. This conclusion is not affected by State law. In any event, even if title does not determine ownership under applicable State law, and even if the IRA owner's Spouse's property interests in the IRA are identical to the owner's under applicable state law, distributions from the IRA are to be taxed as if the owner is the sole owner of the IRA. Thus, since amounts are to be included in an individual's gross income when they are paid or distributed from an IRA, as noted above pursuant to section 408(d)(1) of the Code, we conclude with respect to the ruling request number three that the transfer of Taxpayer B's marital property interest in IRA X and IRA Y to IRA Z constitutes a taxable distribution for purposes of section 408(d)(1).

It is interesting to note that the Service cited absolutely no authority for its position. The Service then went on to state that even if a Spouse is the owner of one-half of an IRA account under state law, distributions from the IRA are to be taxed as if the Account Owner is the sole owner of the IRA. Again, no authority was cited for this proposition. In the author's opinion, both of these conclusions are incorrect and inconsistent with well-established judicial precedent.

Legal Analysis

As mentioned previously, the IRS acknowledged that I.R.C. § 408(g) "does not abrogate any substantive rights under state law" in PLR 199937055. Accordingly, a Spouse may possess a community property interest in an IRA to the extent the existence of that interest is consistent with state law.

I.R.C. § 408(d)(3)(A) provides that § 408(d)(1) does not apply to any amount paid or distributed out of an IRA for whose benefit the account is maintained if the entire amount received is paid into an IRA for the benefit of such individual within 60 days. § 408(d)(3)(A) allows rollovers for "the individual for whose benefit the account is maintained"; its application is not limited to a person in whose name the account has been established. Furthermore, Rev. Rul. 78-406, 1978-2 C.B. 157 provides that the direct transfer of funds

from one IRA trustee to another IRA trustee does not result in such funds being paid or distributed to the Account Owner, and that such a transfer is therefore not subject to income taxation.

There cannot be any doubt that an IRA is maintained for the benefit of the person (or persons) who own it. In a community property jurisdiction, the participant's Spouse is the owner of a one-half interest in an IRA, which is classified as community property. Thus, Spouse owns one-half of the Original IRA. Likewise, under the facts set forth above, Spouse is the sole owner of the Spousal IRA because that IRA has been classified as her individual property by a property agreement between the spouses. Accordingly, a transfer of Spouse's interest in the Original IRA to the Spousal IRA should not be taxable so long as the 60 day requirement of § 408(d)(3)(A) is satisfied. In accord, see PLRs 9630034, 9439020 and 8040101.

Furthermore, if Spouse's interest in the Original IRA is transferred by the custodian thereof directly to the custodian of the Spousal IRA, the requirements of Rev. Rul. 78-406 should be satisfied. Thus, a direct transfer of Spouse's interest from the custodian of the Original IRA to the custodian of the Spousal IRA should likewise be non-taxable.

In PLR 19993705, the IRS supported its conclusions by stating that property rights established by state law could be ignored when determining how IRA distributions are to be taxed. The critical question then becomes whether the IRS can ignore the existence of the Spouse's property rights when applying the Internal Revenue Code. Notwithstanding its admission that § 408(g) was not intended to preempt state law in this respect, the PLR apparently takes the position that the Service can ignore state-created property interests even in the absence of preemption. The courts which have considered this question have uniformly held to the contrary.

In U.S. v. Mitchell, the U.S. Supreme Court considered whether a married woman domiciled in the community property state of Louisiana was personally liable for federal income tax on half of the community income realized during the existence of the community despite the exercise of her statutory right of exoneration. The Court held that the spouse was liable for the federal income tax on one-half of the community income. In doing so, the Court stated:

> [T]hus, with respect to community income, as with respect to other income, federal income tax liability follows ownership. Blair v. Commissioner, 300 U.S. 5, 11-14 (1937). See Hoeper v. Tax Comm'n, 284 U.S. 206 (1931). In the determination of ownership, state law controls. 'The state law creates legal interests but the federal statute determines when and how they shall be taxed.' Burnet v. Harmel, 287 U.S. 103,110 (1932); Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940); Helvering v. Stuart, 317 U.S. 154, 162 (1942); Commissioner v. Harmon, 323 U.S. 44, 50-51 (1944); See Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

The dates of the cited cases indicate that these principals are long established in the law of taxation. Thus, it seems clear that the IRS must defer to state law when determining the property rights of taxpayers to the extent those rights result in the imposition of an income tax. Where, as here, both spouses have identical ownership interests in an IRA under State law, the IRS should be obligated to treat those property interests in the same manner when applying the Internal Revenue Code. "It was the object of Congress to provide a uniform basis of taxation in order to secure uniformity in the burdens imposed. 'Equality is equity.'" Pacific Ins. Co. v. Soule, 74 U.S. 433 (1868) at 433.

Conclusion

Because Spouse is the owner of one-half of the Original IRA, Spouse should be entitled to transfer her one-half interest to her Spousal IRA without the imposition of an income tax. While the IRS has chosen to disagree with this conclusion, the Service has acknowledged that a Spouse may own a community property interest in an IRA and that the classification of an IRA as marital (or community) property by an agreement between the spouses will not trigger current income taxes. Therefore, PLR 199937055 in large part supports the proposition of Part I of this article; namely, it should be possible to transfer Spouse's interest in the Original IRA to the Spousal IRA upon the death of either the Account Owner or Spouse without triggering current income taxation. Unfortunately, at the present time the IRS is unwilling to confirm this conclusion.

Endnotes

See also United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985). (State law determines whether the taxpayer has sufficient interest to satisfy the requirements for taxation under federal law);. U.S. v. Denlinger, 982 F.2d 233, 235 (7th Cir.1992). ("The basic rules are simple. State law determines what interest, if any, a taxpayer has in property."); U.S. v. Davenport, 106 F.3d 1333, 1335 (7th Cir.1997). (State law determines what interest a taxpayer has in property); United States v. Rodgers, 461 U.S. 677, 683 (1983). (It has long been an axiom of our tax collection scheme that, although the definition of underlying property interests is left to state law, the consequences that attach to those interests are a matter left to federal law); Chicago Mercantile Exchange v. U.S., 840 F.2d 1352, 1355 (7th Cir. 1988). (The nature and extent of the taxpayers interest is a matter of state law); Estate of Young v. Commissioner, 110 T.C. 297, 301 (1988). (It has been established that what constitutes an interest in property held by a person within a state is a matter of state law. On the other hand, once property rights are determined under state law, federal law is utilized to decide the tax consequences); Estate of Benjamin Shapiro, 1993 RIA TC Memo 93,483. (It is well established that, in general, state law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed); Steiner v. Commissioner, 69 T.C.M. (CCH) 2176 (1995). (Although state law generally does not control the treatment of a transaction for federal income tax purposes, state law determines the legal rights and interests of the parties to the transaction and this may affect the application of federal law); Fernandez v. Wiener, 326

U.S. 340, 355-357 (1945). (What constitutes an interest in property held by a person within a state is a matter of state law).