

ERRATA & UPDATES

ADDENDUM TO *THE KILLING OF COMMUNITY PROPERTY*

Karen S. Gerstner*

In my article, *The Killing of Community Property*, I declared that Section 408(g) of the Internal Revenue Code (the “Code”) is too broadly worded and has been too broadly interpreted and applied by federal courts and the Internal Revenue Service (the “IRS”).¹ I also opined that Section 408(g) needs to be modified by Congress.²

Section 408(g) provides, “This Section shall be applied without regard to any community property laws.”³ Section 408(g) is an income tax provision that applies to IRAs.⁴ As evidence that Section 408(g) has been too broadly interpreted (and, also, that it has been interpreted and applied using a common law—or anti-community property law—bias), in my article, I discussed Private Letter Ruling 201623001.⁵

In PLR 201623001, the husband, as the titled owner (“participant”) of three IRAs that were allegedly community property under applicable state law, named his son (“Taxpayer B”) as the 100% primary beneficiary of the IRAs (collectively, the “IRA”).⁶ After husband’s death, the IRA custodian transferred the IRA titled in husband’s name to an inherited IRA for son.⁷ Husband’s surviving wife (mother of son) filed a state court action seeking to recover her community property ownership interest in the IRA.⁸ Wife and son reached an agreement in which wife’s community interest in the IRA titled in husband’s name was valued at “Amount 1.”⁹ The state court approved the settlement and directed the IRA custodian to distribute Amount 1 out of son’s inherited IRA to a spousal IRA rollover for wife.¹⁰ Admittedly,

* Sole shareholder of Karen S. Gerstner & Associates, P.C. J.D., Case Western Reserve University School of Law; B.A., Miami University, graduated *cum laude*.

1. Karen S. Gerstner, *The Killing of Community Property*, 11 EST. PLAN. & COMMUNITY PROP. L.J. 1 (2018).

2. See Gerstner, *supra* note 1, at 47–57 (2018).

3. 26 U.S.C. § 408(g).

4. Section 408(g), Individual Retirement Accounts, is within Subchapter D, Deferred Compensation, etc., of Subtitle A, Income Taxes, of the Internal Revenue Code of 1986, as amended.

5. See Gerstner, *supra* note 1, at 31–33 and 47–57 (2018).

6. I.R.S. Priv. Ltr. Rul. 201623001 (June 3, 2016).

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

a better approach would have been for wife to seek her interest in the IRA titled in husband's name prior to it being distributed to an inherited IRA for son (as was done in Private Letter Ruling 200150036, discussed below).¹¹ It is doubtful, however, in view of the IRS's reasoning in PLR 201623001, that such a change in the post-death procedure would have made any difference in the IRS's ruling.¹² In PLR 201623001, the Service stated:

In regard to the second, third, and fourth ruling requests, Taxpayer B was the named beneficiary of the IRA of Decedent and the IRA has been retitled as an inherited IRA for Taxpayer B. Section 408(g) provides that section 408 shall be applied without regard to any community property laws, and, therefore, section 408(d)'s distribution rules must be applied without regard to any community property laws. Accordingly, because Taxpayer A was not the named beneficiary of the IRA of Decedent and because we disregard Taxpayer A's community property interest, Taxpayer A may not be treated as a payee of the inherited IRA for Taxpayer B and Taxpayer A may not rollover any amounts from the inherited IRA for Taxpayer B (and therefore any contribution of such amounts by Taxpayer A to an IRA for Taxpayer A will be subject to the contribution limits governing IRAs). Additionally, because Taxpayer B is the named beneficiary of the IRA of Decedent and because we disregard Taxpayer A's community property interest, any "assignment" of an interest in the inherited IRA for Taxpayer B to Taxpayer A would be treated as a taxable distribution to Taxpayer B. *Therefore, the order of the state court cannot be accomplished under federal tax law* (emphasis added).¹³

Clearly, the "federal tax law" that prevented wife from securing her community property ownership interest in the IRA titled in husband's name after husband's death was Section 408(g).¹⁴

Section 408(g) was incorrectly applied by the IRS in PLR 201623001.¹⁵ Based on the particular references to community property in Title I and Title II of the Legislative History of ERISA, it is clear that Congress intended to ignore community property law for purposes of contribution limits, excess contributions and lump sum contributions while the participant is living.¹⁶ In addition, based on Private Letter Ruling 199937055, distributions from an IRA while the participant is living are to be determined without regard to community property laws.¹⁷ Nothing in the legislative history of Section 408(g) indicates that it was intended to be applied *after* the death of the

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. See Gerstner, *supra* note 1, at 47–57.

16. See Gerstner, *supra* note 1, at 44.

17. I.R.S. Priv. Ltr. Rul. 199937055 (Sept. 17, 1999); see also Gerstner, *supra* note 1, at 46–47.

participant.¹⁸ Section 408(g) is an income tax rule applicable while the participant is alive.¹⁹ Once the participant dies, the marriage ends and new income tax rules apply to the beneficiaries of the participant.²⁰ In its ruling in PLR 201623001, the IRS applied a federal income tax provision, i.e., Section 408(g), applicable while the participant is still alive, to override state marital property laws applicable on the termination of the marriage due to the death of the participant.²¹

State law normally determines the ownership and proper distribution of assets on hand when a marriage terminates due to the first spouse's death.²² Tax consequences based on the ownership of assets usually follow state law property ownership determinations.²³ There is no clear Congressional intent to apply Section 408(g) *after the death of the participant* in regard to a matter usually determined by applicable state law (i.e., the division and distribution of assets on termination of a marriage due to the death of the first spouse).²⁴ As indicated in Private Letter Ruling 8040101 (July 15, 1980), discussed in my article, "section 408(g) does not abrogate any substantive rights under State law" in the case in which a marriage terminates due to the death of a spouse.²⁵

Even though Section 408(g) is too broadly worded and has been applied in a context beyond what was intended, I did not mean to imply in my article that Section 408(g) should be modified to change the current IRA contribution and distribution rules in the case in which the titled owner of the IRA, i.e., the participant, is alive *just because the particular IRA would be community property under applicable state law*.²⁶ In other words, even if an IRA is owned as community property under state law, it does not necessarily follow that required minimum distributions ("RMDs") from the IRA during the participant's life should be calculated based on the joint lives of the spouses.²⁷ As long as the participant is living, RMDs should be calculated as if the participant were the sole owner of the IRA (i.e., without regard to community property laws).²⁸ In addition, the participant should be

18. See Gerstner, *supra* note 1, at 44.

19. *Id.*; see *supra* note 4.

20. Natalie B. Choate, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS § 1.5 (6th ed., 2006).

21. See Gerstner, *supra* note 1, at 31–33 and 47–57 (2018).

22. *Id.*

23. *Id.*

24. See Gerstner, *supra* note 1, at 44–46.

25. I.R.S. Priv. Ltr. Rul. 8040101 (July 15, 1980), discussed in Gerstner, *supra* note 1, at 44–46.

26. See Gerstner, *supra* note 1, at 53–55.

27. *Id.*

28. *Id.* Note that, when I say that required minimum distributions should be calculated as if the participant were the sole owner of the IRA, I am not saying that the rule allowing a joint and survivor distribution in the case in which the participant has named his more than ten years younger spouse as the sole beneficiary of his IRA should be changed, I am just saying that community property law should be ignored for purposes of calculating required minimum distributions while the participant is living; see 26 C.F.R. § 1.401(a)(9)-5, A-4(b) (2012).

responsible for income taxes payable on distributions taken from “his” IRAs while he is alive and his marriage is still intact.²⁹ Any other rule would impose a huge burden on participants and IRA custodians and trustees.³⁰ Further, any other rule would clearly conflict with the income tax purpose of Section 408(g).³¹

My point is that Section 408(g) is an income tax rule and should not be applied in the context of ownership of an IRA on termination of the marriage by the death of the first spouse.³² Applying Section 408(g) when a marriage terminates due to the death of the first spouse in a manner that abrogates community property ownership under state law (as in PLR 201623001) conflicts with numerous federal court decisions and rulings that recognize community property law.³³ In addition, Congress never expressly stated its intent that, by passing Section 408(g), the ownership of IRAs as community property was precluded.³⁴ My concern is that Section 408(g), a federal income tax rule, should not be applied to override state property ownership laws, especially in cases in which the IRA participant is no longer alive.³⁵

In regard to both qualified plans and IRAs (“retirement plans”), federal law recognizes that marriages terminate by divorce.³⁶ Federal law has chosen to respect applicable state property laws (including marital property laws) when the retirement plan participant and his spouse obtain a divorce.³⁷ In the case of termination of a marriage by divorce, federal law recognizes that retirement plans are not just sources of income (implicating the federal income tax rules), but assets that must be divided upon divorce.³⁸

On the other hand, with respect to retirement plans, federal law does not always recognize that marriages terminate by death as well as divorce, at which time, state law primarily determines the ownership and distribution of the assets on hand at that time.³⁹ Thus, in PLR 201623001, Section 408(g) (an income tax provision) was applied to preclude state property law ownership of an IRA for purposes of division of the IRA upon termination of the marriage due to the participant’s death.⁴⁰ If an IRA in the participant’s name is community property under state law, the participant’s spouse owns

29. *Id.*

30. *Id.*

31. *Id.*

32. See Gerstner, *supra* note 1, at 31–33 and 47–57 (2018); see also *supra* note 4.

33. See, e.g., *Poe v. Sanborn*, 282 U.S. 101 (1930); Rev. Rul. 67-383, 1967-2 CB 325 (Jan. 1, 1967); *Lang v. Comm’r*, 304 U.S. 264 (1938); *Freedman v. U. S.*, 382 F.2d 742 (5th Cir. 1967); Rev. Rul. 2003-40, 2003-1 CB 813 (Apr. 25, 2003).

34. I.R.S. Priv. Ltr. Rul. 8040101 (July 15, 1980),

35. See Gerstner, *supra* note 1, at 43–57.

36. See 26 U.S.C. § 414(p) and 26 U.S.C. § 408(d)(6) (2006); see also I.R.S. Priv. Ltr. Rul. 8040101 (July 15, 1980),

37. *Id.*

38. *Id.*

39. See, e.g., *Boggs v. Boggs*, 520 U.S. 833 (1997).

40. I.R.S. Priv. Ltr. Rul. 201623001 (June 3, 2016).

a community property one-half interest in the IRA in her own right and, under the facts in PLR 201623001, when the marriage has terminated because of the participant's death, the surviving wife should be able to obtain her community ownership interest in the IRA upon the participant's death, without the son being deemed to be making a taxable distribution on transfer of the wife's community property ownership interest in the IRA to the wife pursuant to the local court order.⁴¹ The result in PLR 201623001 appears even more biased against community property law when compared to the result in PLR 200150036 (discussed below).⁴² Section 408(g), which imposes income taxes on IRA distributions to the participant during his lifetime without regard to community property laws, was never intended to be applied in the manner applied in PLR 201623001.⁴³

Treating a living participant as the sole owner of a community property IRA for federal income tax purposes does not hinder recognition of the community property ownership of the IRA in community property states that have not adopted a terminable interest rule.⁴⁴ Lawyers in community property states are used to this dichotomy between the federal income tax laws and state property laws and accept the rule in Section 408(g) that distributions from an IRA while the participant is alive must be based on the participant being deemed to be the sole owner of the IRA for federal income tax purposes.⁴⁵ PLR 201623001 involved termination of the marriage due to the participant's death.⁴⁶ Marriages also terminate if the nonparticipant spouse dies first.⁴⁷ The death of the nonparticipant spouse (survived by the participant) does not trigger any changes to otherwise applicable federal income tax rules.⁴⁸ In that case, if the nonparticipant spouse devises her community property interest in the IRA titled in the participant's name to someone other than the participant (in Texas, for example, she would do this by a specific provision in her Will), the participant will continue to be treated as the sole owner of the IRA under the federal income tax laws, even if the participant does not own 100% of the IRA titled in his name under applicable

41. *Id.*

42. I.R.S. Priv. Ltr. Rul. 200150036 (Aug. 10, 2001).

43. See Gerstner, *supra* note 1, at 31–33 and 47–57.

44. See Karen S. Gerstner, *Current Issues Related to Estate Planning With Qualified Retirement Plans and IRAs*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING AND PROBATE COURSE, June 27–29, 2012, at 15–18.

45. *Id.* (stating that the participant is the sole “owner” of the IRA for purposes of calculating required minimum distributions while he is alive is not intended to overlook the sometimes applicable provision that allows a living participant who has named his more than ten years younger spouse as his beneficiary to calculate required minimum distributions during his life using the joint and last survivor table); see 26 C.F.R. § 1.401(a)(9)-5, A-4(b).

46. I.R.S. Priv. Ltr. Rul. 201623001 (June 3, 2016).

47. See I.R.S. Priv. Ltr. Rul. 8040101 (July 15, 1980).

48. *Id.*

state property laws.⁴⁹ In other words, distributions from the IRA will be made to the participant during his life without regard to community property laws.⁵⁰ If the nonparticipant spouse leaves her community property interest in the IRA titled in the participant's name to someone other than the participant upon her death, lawyers in community property states that recognize this transfer as a valid transfer under applicable state law will document the co-ownership of the IRA for state law purposes.⁵¹ That IRA co-ownership agreement is executed by the participant and the nonparticipant spouse's "Will beneficiaries."⁵² Per the co-ownership agreement, "if, as and when" the participant takes distributions from the IRA titled in his name, the participant will pay income taxes on those distributions; but following that, the participant will remit the net after tax amount that belongs to the nonparticipant spouse's Will beneficiaries to those beneficiaries.⁵³ Among other provisions, the co-ownership agreement will require the participant to name the nonparticipant spouse's Will beneficiaries as the beneficiaries of their applicable ownership interests in the co-owned IRA so that, upon the participant's death, they will receive their applicable shares of the participant's IRA.⁵⁴

Finally, in my article, I charged that federal courts and agencies have decided cases involving community property based on a common law bias.⁵⁵ As further evidence of that accusation, compare Private Letter Ruling 201623001 to Private Letter Ruling 200150036.⁵⁶ The facts in PLR 200153005 are analogous to the facts in PLR 201623001, *except that the married couple in PLR 200150036 was residing in a common law state*, rather than a community property state, as of the participant's date of death.⁵⁷ In PLR 200150036, the husband died, having named persons other than his surviving wife as the beneficiaries of his two IRAs.⁵⁸ The surviving wife exercised her right under state law to elect to take her elective share of her deceased husband's estate, rather than what was provided for her under her husband's Will.⁵⁹ Apparently, for purposes of its elective share rules, the particular state in which the couple resided embraced the concept of an augmented estate that included the deceased husband's IRAs (the IRS did not have any trouble relying on these stated facts—contrast that with PLR

49. This result recognizes recent interpretations of Section 408(g), but actually differs from the result in I.R.S. Priv. Ltr. Rul. 8040101 (July 15, 1980); *see* Gerstner, *supra* note 1, at 18–20.

50. *Id.*

51. *See* Gerstner, *supra* note 44.

52. *Id.*

53. *Id.*

54. *Id.*

55. *See* Gerstner, *supra* note 1, at Part III.

56. I.R.S. Priv. Ltr. Rul. 200150036 (Aug. 10, 2001).

57. *Id.*

58. *Id.*

59. *Id.*

201623001, in which the IRS was not able to rely on the assertion that the IRA in question was community property under applicable state law).⁶⁰ The wife filed her Petition for Election with a court of competent jurisdiction and that court ruled that the surviving wife was entitled to receive Sum 1 from one of the participant's IRAs and Sum 2 from the participant's other IRA.⁶¹ In its ruling on the resulting federal income tax issues, the IRS stated (i) the surviving wife would be treated as the payee or distributee of her elective share of the IRAs for purposes of Section 408(d)(3); (ii) to the extent of the surviving wife's elective shares in the participant's two IRAs, those portions will not be treated as inherited IRAs within the meaning of Section 408(d) with respect to the surviving wife; (iii) the surviving wife is eligible to roll over the portions of the participant's IRAs distributable to her to IRA rollovers set up and maintained in her name pursuant to Section 408(d)(3)(A)(i) as long as the rollovers occur within 60 days following the day the sums allocable to the wife are distributed from the participant's IRAs; and (iv) the surviving wife will not be required to include in her income for federal income tax purposes for calendar year 2001 (the year in which the distributions occur) the amounts distributed to her from the participant's IRAs.⁶² Thus, unlike in PLR 201623001, the surviving wife in PLR 200150036 was allowed to obtain her "ownership interest" (is an elective share equivalent to an ownership interest?) in the deceased participant's IRAs based on state marital property laws applicable on the death of the first spouse and neither the surviving wife nor the named beneficiaries of the participant's IRAs suffered adverse income tax consequences as a result.⁶³

In summary, although I believe Section 408(g) needs to be modified by Congress, I am not advocating changing the application of Section 408(g) during the life of the participant. Clearly, however, Section 408(g) should not be applied after the participant dies to deny a surviving spouse her community property ownership interest in an IRA titled in the participant's name that is community property under substantive state law.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*