Estate Planning Insights

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COMMUNITY PROPERTY MURDERED BY FEDERAL AGENTS!

SPECIAL EDITION NO. 2

Introduction. The first "Special Edition" on this topic, dated May 31, 2019, applied to qualified employee benefit plans (often simply referred to as "qualified plans"). Examples of qualified plans include 401(k) plans and profit-sharing plans. Qualified Plans are governed by the Employee Retirement Income Security Act of 1974–ERISA. This second "Special Edition" will focus on Individual Retirement Accounts–IRAs. Although both qualified plans and IRAs are "retirement plans" and both are subject to most of the same income tax rules, IRAs are *not* qualified plans governed by ERISA.

As noted in the first Special Edition in this series, certain actions taken by (i) members of the US Congress who enact federal legislation, (ii) federal judges who write opinions in federal court cases, and (iii) lawyers who write rulings for the Internal Revenue Service ("IRS"), who we are collectively calling "federal agents," have slowly but surely been "murdering" community property in the context of retirement plans. Perhaps these federal agents have done this, and continue to do this, because *either* (i) they do not understand community property *or* (ii) they have a "common law outlook" when it comes to marital property law. It is possible, however, that some of these federal agents have taken action as a result of a bias against–and even a hostility toward–community property law. Regardless of the motive, the result is the same: a *huge* loss of valuable property rights for married people living in community property states.

The Murder of Community Property Involving an IRA. Here's what happened.

A married man living in a community property state named his adult son as the 100% primary beneficiary of the IRA titled in his name. The facts in the reported case are not totally clear, but it appears that the son was the child of the husband and his surviving wife. *Why* did the husband name his son as the 100% beneficiary of the IRA titled in his name? (He should have named his wife to receive at least 50%.) Hopefully, the husband's advisors did not tell him to do that simply because of the son's younger age and the possibility of "stretching" required minimum distributions from the IRA over the son's life expectancy after the husband's death. That approach would violate the maxim, "Don't let the tax tail wag the dog." It also might be called, "knowing enough to be dangerous."

After the husband died, his surviving wife sought to obtain *her* community property one-half interest in the IRA titled in her husband's name. Here we must stop and make sure our readers understand some basics regarding community property law.

Community Property Law Summary. Recall our rather extensive discussion of community property law in our prior newsletter. If an IRA is acquired and/or accumulated while a married person is living in Texas (or any other community property state), the IRA is community property under state law. It does not matter that, per federal law, an IRA is always titled solely in the name of one individual. Community property states, like Texas, are *not* "title states." In a title state (a/k/a common law state), the title of an asset tells you the owner of the asset. That is not true in a community property state. As we have discussed many times, in the case of a married couple domiciled in Texas, the title of an asset does *not* tell us the owner of the asset. At most, the title of an asset *may* tell us the *manager* of the asset. And in some community property states, the title of the asset does not even indicate the manager of the asset because, in those states, both spouses have management rights over community property assets, regardless of how they are titled.

In Texas, we have various types of community property based on who has the right to manage (or, *control*) the asset. Of course, many assets owned by married couples in Texas are joint management community property assets–community property subject to the management and control of both spouses. However, we also have "sole

management community property"–community property that is managed solely by one spouse. *Management and ownership are two different things.* One can own something and not have the right to manage it and one can manage something and not own any ownership interest in it. In the case of community property that is subject to the sole management of one spouse (for example: an IRA titled in one spouse's name), the spouse who is managing that asset must remember that the other spouse has an ownership interest in it. In fact, the managing spouse has a *fiduciary duty* to take into account the ownership interest of the other spouse when managing the asset. The managing spouse cannot fraudulently dispose of the other spouse's community property interest in the community property asset he is managing. That is why we said earlier that the husband should have named his wife as the beneficiary of at least 50% of the IRA titled in his name.

Because marital property ownership in Texas is not based on the title of the asset, one must find out *how* and *when* a particular asset was acquired to determine the ownership of the asset. It's more complicated than in the title (or, common law) states. If an asset was acquired during the marriage other than by gift or inheritance and other than with assets owned prior to the marriage, it is community property. In fact, we have a presumption in Texas that all assets on hand when the marriage terminates–whether by death or divorce–are community property.

Compensation paid to either spouse during the marriage is "classic" community property. Compensation comes in many forms, including, but not limited to salary, bonuses, commissions, fees, net profits from a business, etc. Compensation is what goes into employee benefit plans and IRAs, including IRA rollovers from employee benefit plans. As previously discussed, compensation received by a married person living in a community property state is community property even though paid to (or, "titled") solely in the name of that spouse. In addition, in all of the community property states, income earned by community property assets during the marriage is also community property.

For simplicity, community property assets can be thought of as assets that are owned 50% by each spouse, in undivided interests, *regardless of title and regardless of control or management rights*.

The Wife's Court Action. In the *murder case* we are currently discussing, the husband's IRA was community property. After the husband died, the wife filed a petition with the probate court, asking the court to "award to her" her community property interest in the IRA titled in the husband's name. Although it might seem as if the wife's action constituted the filing of some sort of "contested proceeding," that is not necessarily the case. Persons with an interest in assets owned by a decedent (i.e., a deceased person) can "petition" a court having the necessary jurisdiction to obtain an Order indicating the ownership rights of all "interested persons" in the asset(s) in question. Thus, the legal action taken by the wife did not necessarily amount to a "conflict" between the wife and her son. And, as will be noted later, the wife almost certainly had to take the action she did in this case to avoid being treated as making a "taxable gift" to her son of her community property ownership interest in the IRA titled in the husband's name that became distributable to the son upon her husband's death.

Based on applicable state law, the court agreed that the surviving wife owned a community property interest in the IRA titled in her husband's name. The court then issued an Order, directing the IRA custodian to transfer to an IRA established for the wife the amount representing the wife's community property interest in the IRA that was titled in the husband's name when he died.

Section 408(g) of the Internal Revenue Code. By the time the court issued its Order, the entire IRA titled in the husband's name had already been transferred to an "inherited IRA" for the benefit of the son. The IRA custodian wanted guidance on the proper tax reporting. Therefore, the wife sought a "private letter ruling" ("PLR") from the IRS on the income tax consequences of transferring her community property interest held in the son's inherited IRA to the new IRA established in her name. Unfortunately, the IRS ruled that such a transfer "could not be accomplished under the federal tax laws" without triggering income taxes on the full amount transferred from the son's inherited IRA to the wife. In other words, if the wife's ownership interest were transferred out of the son's inherited IRA to the proposed new IRA titled in the wife's name, that would be treated as a withdrawal or distribution from the son's IRA, which would be fully taxable to the son. Thus, if the transfer were made in accordance with the court's Order, the income tax consequences to the son would be severe. The consequences to the wife would be severe, too, because her "retirement funds" (i.e., the amount of her ownership interest in the IRA that was titled in her husband's name when he died) would be substantially reduced by the "up front" payment of income taxes on that entire amount.

The federal tax law the IRS was referring to was Section 408(g) of the Internal Revenue Code (the "Code"). Section 408(g) states, "This section shall be applied without regard to any community property laws." What does that mean, exactly? First, note that Section 408(g) is in Subtitle A of the Code. Subtitle A relates to income taxes. A different section of the Code–Subtitle B--applies to taxes on the "transfer" of assets (i.e., estate and gift taxes). Further, Section 408(g) is clearly a federal income tax provision and not a provision designed to address substantive property rights under state law.

We have reviewed the legislative history of Code Section 408(g) to try to determine what Congress intended by passing that provision. In our opinion, in passing Section 408(g), Congress intended to ignore community property laws primarily with respect to income tax matters, such as IRA contribution limits. Nothing in the legislative history of Section 408(g) indicates congressional intent to override community property law for all purposes with respect to IRAs, including ownership of IRAs under state law. Furthermore, it is doubtful that Congresspersons from community property states would have voted to pass Section 408(g) if they understood that they were preempting community property ownership of IRAs accumulated by married persons living in community property states.

In an earlier PLR issued by the IRS, discussing whether Section 408(g) of the Code preempted the deceased spouse from owning a community property interest under state law in an IRA titled in the surviving spouse's name, the IRS stated, "The relationship of section 408(g) and the community property laws of State D must be evaluated against Congress' intent in enacting the section." After noting that Congress specifically recognized community property law in the case of the division of an IRA on divorce, the IRS also said, "As a general rule, the death of one spouse in a community property State has the same effect on the community as a divorce decree. Upon either death or divorce, the community is terminated and a division of the community property usually occurs. It would follow that a similar result should be reached whether the community is ended by divorce or death. Because there is no specific language on what effect Congress intended Code section 408(g) to have, and because of the general rule of statutory construction which provides that federal statutes are construed as to not preempt State law unless that was the clear and manifest intent of Congress, we conclude that section 408(g) does not abrogate any substantive rights under State law."

Unfortunately, in the recent "murder case" we have been discussing, the IRS took a different position than it did in that earlier PLR. The IRS's ruling in our murder case does have the effect of "preempting" or "taking away" the surviving wife's community property ownership interest in the IRA that was titled in the husband's name when he died. If the son has to pay income taxes on that full amount, the "penalty" of the wife asserting her state law ownership rights is very severe. That penalty hurts both the son and the surviving wife.

As noted earlier, there is also a federal gift tax issue in this case. If the surviving wife did *not* seek to obtain her community property ownership interest in the IRA after her husband's death, per various federal gift tax cases, the wife would be treated as making a "taxable gift" to the son of her community property ownership interest in the IRA upon the husband's death. This case is a disaster!

<u>Bottom Line</u>: Section 408(g), an income tax provision, was applied by the IRS in the ruling we have been discussing to abrogate substantive state law property rights. Congress never intended Section 408(g) to be used that way. Further, we do not see any "risk" to the federal collection of income taxes with respect to IRAs due to recognizing the community property ownership of IRAs. If the wife's ownership interest in the IRA titled in the husband's name had been transferred to a new IRA in the wife's name, without imposing immediate income taxes on that transfer, required minimum distributions would have been made to the wife from her IRA over her life expectancy, plus ten years, pursuant to the Uniform Lifetime Table. That is a shorter time period than the time period applicable to the son. Thus, the IRS would have collected *more* income taxes, *sooner*, if community property had been recognized.

The IRS has also written a publication that states that Section 408(g) overrides community property law in the case of IRAs. In Publication 555, the IRS states that IRAs are the "separate property" of the named IRA owner. That is totally false and no federal court has so held. Apparently, the IRS, a regulatory agency, believes it has the authority to override substantive property rights under state law based on its interpretation of Code Section 408(g). The IRS's actions clearly amount to the taking of property without due process of law. We strongly believe that Congress needs to clarify that Section 408(g) only applies for income tax purposes and only applies while the named IRA owner is living. Section 408(g) should not be applied after the IRA owner dies to override substantive property rights, such as community property law.

The Killing of Community Property. We mentioned last time that Karen Gerstner's article, *The Killing of Community Property*, was published by Texas Tech Law School's *Estate Planning and Community Property Law Journal*. *See* Volume 11, Book 1 (Fall 2018). Subsequent to that, Karen Gerstner published an Addendum to *The Killing of Community Property* in the same law journal. *See* Volume 11, Book 2 (Spring 2019). One of the major points made in the Addendum was that the IRS has a bias against community property law. In support of that contention, a PLR with facts that were very similar to the "murder case" discussed in this newsletter but involving a couple living in a common law state (i.e., a non community property state) was decided by the IRS in a manner very favorable to the surviving spouse. In other words, in that other PLR, someone other than the surviving wife was named as beneficiary of the husband's IRA and, after the husband's death, the wife claimed her "elective share rights" under applicable state law. In that ruling, the IRS held that there would be no income tax consequences resulting from the transfer of the surviving wife's "elective

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share" (i.e., ownership interest) in the husband's IRA to a new IRA established for the surviving wife. Basically, that ruling involved the same facts as in our *murder case*, but with a totally different tax result. In other words, on basically the same facts, the IRS issued a favorable ruling when applicable state law was *not* community property and an adverse ruling when applicable state law *was* community property.

Solutions. In this series of newsletters, we described two separate "murders" of community property: one involving a qualified plan and the other involving an IRA. We believe there is a simple solution to fix the IRA problem: Congress should modify Section 408(g) of the Code to make it clear that it applies solely for federal income tax purposes (such as contribution limits) while the named IRA owner is living and does *not* apply after the named IRA owner dies--and certainly does not apply for purposes of determining substantive property rights under state law. When Section 408(g) was passed, there was no evidence that Congress intended Section 408(g) to apply after the IRA owner's death to determine whether an IRA is community property or separate property under state law. It is only the "faulty reasoning" of the IRS that has resulted in this untenable position.

Fixing the problem involving qualified plans is a little bit more complicated due to ERISA, but we have a proposed solution for that problem, too. Basically, the solution involves creating a "special probate court order" on the death of the *nonparticipant spouse* (the spouse of the spouse who is the participant in the qualified plan) that results in the participant's qualified plan (both his community property interest and his deceased spouse's community property interest) remaining fully available to the participant until the participant dies, at which time, the nonparticipant spouse's interest can be distributed to *her* beneficiaries.

If any of our readers know someone in the US Congress who might be interested in fixing these problems (and protecting the millions of married people living in community property states who own retirement plans worth billions of dollars), please let us know!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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