MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

SEPTEMBER 2016 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

IN THIS ISSUE

COMMUNITY PROPERTY INTERESTS DISREGARDED WITH IRAS

by Bradford N. Dewan, J.D., MBA

In Private Letter Ruling (PLR) 201623001, the IRS refused to allow a surviving spouse to roll over a portion of the deceased spouse's IRAs that had been "assigned" to her by the couple's son. The son was the sole beneficiary named on the beneficiary designation forms. This family lived in a "community property" state. Thus, the surviving spouse claimed that she had a "community property" interest in her deceased spouse's three IRAs. The son, the decedent's estate, and the local state court accepted the claim. The IRS denied the request to have the assigned funds treated as a spousal rollover based on the community property claim. The IRS based its decision on IRC section 408(g) which states: "This section shall be applied without regard to any community property laws."

<u>Background</u>

A married IRA owner, who resided in a community property state, named his child as the sole beneficiary of his three IRAs. After the owner passed away, the IRAs were retitled as an inherited IRA for the child beneficiary. The surviving spouse then filed a claim against the decedent's estate for a one-half interest in the community property that the deceased spouse and the surviving spouse owned. The surviving spouse and the decedent's estate negotiated a settlement under which the surviving spouse's community property interest in the estate was valued at "Amount 1". Importantly, the settlement was with respect to the community property interest in the total of the decedent's estate (not just in the decedent's IRAs). A state court in the community property state approved the settlement and ordered that the custodian of the IRAs to assign Amount 1 of the son's inherited IRAs to the surviving spouse as a spousal rollover IRA.

The surviving spouse requested a Private Letter Ruling from the IRS asking that:

(1) the negotiated amount (i.e. "Amount 1") should be classified as the surviving spouse's community property interest;
(2) the surviving spouse could be treated as a payee of the child's inherited IRA;
(3) the custodian of the child's inherited IRA could distribute Amount 1 to the surviving spouse in the form of a surviving spouse rollover IRA; and
(4) the distribution of Amount 1 from the child's inherited IRA to the surviving spouse would not be considered a taxable event.

IRS Denies Request

The IRS first references Internal Revenue Code Section 408(d)(1) which provides that "any amount paid or distributed out of any individual retirement plan shall be included in the gross income of the payee or distributee." Section 408(d)(3) is then referenced which permits rollovers by the "individual for whose benefit the [IRA] is maintained." The IRS notes that rollovers are not permitted from inherited IRAs.[1] Inherited IRAs are defined as IRAs where (i) the individual for whose benefit the IRA is maintained acquired the IRA by reason of the death of another individual, and (ii) such individual was not the surviving spouse of such other individual.[2] Section 408(g) is then referenced which states that Section 408 "shall be applied without regard to any community property laws."

Regarding the first ruling request, the IRS declined to make a ruling on whether an amount of the inherited IRA for the child should be classified as the surviving spouse's community property since the IRS deemed that this is a matter of state property law and not a matter of federal tax law.

In regard to the second, third, and fourth ruling requests, the IRS noted that the child was the named beneficiary of the IRAs of the deceased spouse and that the IRAs had been retitled as an inherited IRA for the child. The IRS then denied all of these requests mainly due to Section 408(g) (i.e. Section 408 will be applied without regard to any community property laws.) Therefore, the IRS ruled, Section 408(d)'s distribution rules must be applied without regard to any community property laws. Consequently, since the surviving spouse was not the named beneficiary of the decedent's IRAs and since the surviving spouse's community property interest is to be disregarded, the surviving spouse could not be treated as a payee of the inherited IRA for the child. In addition, the surviving spouse could not roll over any amounts from the inherited IRA for the child. Finally, since the child was the named beneficiary of the decedent's IRAs and because the IRS disregarded the surviving spouse's community property interest, any "assignment" of any interest in the inherited IRA for the child to the surviving spouse would be treated as a taxable distribution to the child. In conclusion, the IRS states: "(T)he order of the state court cannot be accomplished under federal tax law." Thus, the IRS may be implicitly saying that the state court was wrong in trying to address federal tax law issues regarding this IRA.

As a result, the spouse's community property interest is disregarded under federal tax law and the child beneficiary would continue to be viewed by the IRS as the payee of the inherited IRA. Consequently, if the court order were to be carried out with the IRA funds being assigned to the spouse, the withdrawal would be a "double whammy" for the child. Not only would the child lose the inheritance (with the potential for tax deferred growth), but the assignment of the inherited IRA assets from the child to the spouse would be taxable to the child beneficiary and ineligible for rollover to the spouse's IRA.

Conclusion

IRA owners who live in community property states, such as California, have wrestled with the question of how to recognize the non-participant spouse's community property interest in the participant's IRA. Unfortunately, there are very few cases or rulings that address this issue. However, one such case was *Bunney v. Commissioner*[3] which held that when the participant withdrew funds from his IRA and paid them to his wife in satisfaction of her community property interest, that this was a taxable distribution to the participant and not a non-taxable spousal rollover. Thus, this PLR can be viewed as confirming *Bunney* in a post-death situation. Consequently, there is really only one solution to this issue in community property states. A married couple residing in a community property state and wanting to formalize each spouse's community property interest in the other spouse's IRA will need to

[1] IRC Section 408(d)(3)(C).
[2] IRC Section 408(d)(3)(C)(ii).
[3] 114 T.C. 259 (2000).

name each other as beneficiary of their respective IRAs at least to the extent of the nonparticipant's spouse's community property interest in the IRA.

FEDERAL TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

IRS Impersonation Scams on the Rise. Scammers are adapting with technology. The IRS has reported an increase in automated calls claiming to be the IRS. These scammers try to collect 'unpaid taxes' on iTunes accounts or gift cards and threaten with arrest, deportation, and legal action if payment is not immediate. The IRS reminds taxpayers that no personal or financial information should ever be shared over the phone with a caller claiming to be the IRS. The IRS will contact the taxpayer by mail first.

Bills to Increase Federal Gas Tax Hike Unlikely to Be Adopted. The federal Highway Trust Fund will run out of money this month. Previous efforts by Congress to provide a mechanism to fully fund it have merely postponed its demise. Reasons for the shortfall include (i) that the tax has remained at 18.4 cents since 1993, (ii) decreased gas consumption from fuel efficient, hybrid and electric vehicles, and (iii) increased construction costs. According to the American Society of Civil Engineers, the cost of critical infrastructure repairs (roads, bridges, and transit) will exceed the funds currently budgeted for them by $846 billion over the next five (5) years.

Two bills recently introduced in the House would increase the federal gas tax and index it for inflation. H.R. 680, the *Update, Promote, and Develop America's Transportation Essentials Act of 2015* and H.R. 2971, the *Highway Trust Fund Certainty Act* would both increase the tax on gasoline. Under HR 680, the tax would increase in increments to 33.3 cents per gallon by 2018 at which time it would be indexed for inflation. HR 2971 would immediately increase the tax to 28.4 cents per gallon and index it for inflation. Neither bill has the support of President Obama, Hilary Clinton or Donald Trump, presumably because increasing this tax is unlikely to raise sufficient funds to meet the anticipated costs of repairing infrastructure.

STATE TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

FTB Provides Guidance to Dealers in Real Property for Calculating the LLC Fee. The state Franchise Tax Board will be releasing updated guidance and instructions for form 568 answering the question: "Does the cost of goods sold include the adjusted basis of real property held for sale to customers in the ordinary course of business?" The answer is that the fee will include property held for sale to customers, but not property held for investment purposes. For a summary of this question and answer, see FTB:

https://www.ftb.ca.gov/professionals/taxnews/Editions/August-2016.shtml.

For the complete ruling, see:

https://www.ftb.ca.gov/law/rulings/active/2016/01_07142016.pdf.

California Newspapers May Get a Tax Break. After months of negotiations between the Board of Equalization and publishers, California has agreed to reduce the sales tax imposed on newspapers starting in October. The new regulation will give newspapers at least a 53% tax break on subscriptions, because the majority of newspapers today reflect digital content (which is not taxable). Newspapers were exempt from sales tax for almost 50 years until the legislature imposed the tax on July 15, 1991 as a way of addressing a budget deficit. In 2015, California collected an estimated $50 million in revenue from this tax. Californians are unlikely to see any cost savings from this change, because the savings will likely be allocated to paying off debts and rising production costs.

California Notary Fees Increase. The cost of getting documents notarized is increasing for the first time since 1993. Starting January 1, 2017, the maximum fee a Notary can charge for an acknowledgment or a jurat will increase from $10 to $15. Our firm does not charge clients a notary fee for these services.

ADDITIONAL TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

Stolen Money = Taxable Money. In a recent case, Alhadi v. Commissioner of Internal Revenue, a caregiver was found guilty of elder abuse for exerting undue influence over a wealthy, elderly man. The man had written Angelina Alhadi, his caregiver, over $800,000 in checks before catching the attention of the Department of Health and Human Services. Alhadi's failure to report this money as income resulted in more than $1 million in penalties by the IRS.

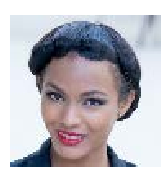
MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A Partnership of Professional Law Corporations

Providing quality legal services since 1959

RALPH GANO MILLER, RETIRED
THOMAS M. MONSON
MARY J. PESHEL
TIMOTHY C. POLACEK
WILLIAM D. HOSHAW†
SUSAN L. HORNER
DeETTE L. LOEFFLER
BRADFORD N. DEWAN
JUDY S. BAE
PHILIP R. FREDRICKSEN†
†OF COUNSEL

http://www.mmpph.com



Editor and Co-Writer: Marica L. Sutton, BA, Communication, University of Louisville, 2011