

IRAs and Community Property

Quick-Take: If an IRA is subject to community property laws, then the rights of a surviving spouse will take priority over the rights of the designated IRA beneficiary.

Background: As we have covered in the past, there are nine states that follow community property principles. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Add to that list Alaska, which has an optional community property regime, and 20% of the states have some sort of community property rules that can frustrate a decedent's intent.

Community Property: In general, community property covers everything acquired by a husband and wife, which they own together, regardless of how title is taken to the asset. Community property includes all money earned during the marriage as well as property that was acquired during the marriage. However, community property state will differ on their respective rules, e.g., some community property states will not treat gifts or inheritances received by a spouse during the marriage as subject to the community property rules.

IRAs: Assets held in an IRA will be treated as community property to the extent that contributions were made to the IRA and earnings accrue to the IRA during the marriage period. These community property rules affect IRAs in two respects.

Divorce: With community property a spouse could claim an interest in the community property, even if it is held in an IRA in the name of the other spouse. This would be a 50% interest in the IRA, even though it is held in the sole name of the other spouse, and even though the other spouse contributed 100% to the IRA during the marriage. Usually, the former spouse's community property interest in the IRA can be transferred to his/her own IRA in a custodian-to-custodian transfer without any income tax consequences to the IRA owner.

Naming Beneficiaries: Inasmuch as community property rules dictate who receives the owner's IRA on his/her death it must be considered when the IRA owner dies. In a community property state, state law will control and recognize the surviving spouse as the beneficiary, even though the IRA owner named someone else as the designated beneficiary of his/her IRA. Restated, while ERISA requires a spouse to sign a waiver which enables the retirement account owner to name someone other than his/her spouse, which is not the case with an IRA, nonetheless with community property it will be important to obtain the waiver/consent of the community spouse if the IRA owner in a community property jurisdiction names someone other than his/her spouse. This is why some IRA custodians have a signature

space on its IRA beneficiary designation form that requires the spouse's waiver and consent if someone other than that spouse is named as the IRA's designated beneficiary.

Taxation of Distributions: While the earnings of community property generally belong to both spouses equally, the same community property laws do not affect the income taxation of distributions from a qualified retirement account.

Qualified Plans: The federal law that gives the participant's spouse certain rights to the participant retirement benefits, e.g., a joint and survivor annuity, preempts state law marital property rights in community property.

IRA: An IRA, in contrast, is not subject to ERISA's spousal-rights rules, and thus the IRA may be community property under applicable state law. However, even though an IRA can be community property under state law, the Tax Code provides that it will be applied without regard to community property laws. [IRC 408(g).] Accordingly, even if the spouses are co-owners of the IRA under their state's law by virtue of community property principles, the Tax Court has made it clear that distributions from that IRA are gross income of only the owner/participant under federal income tax laws. See *Angela C. Morris, Tax Court Memo 2002-17*.

Transfers: Things get a bit more confusing with the transfer of an IRA that is subject to community property rules. A couple of examples suggest how the application of these community property rules can get confusing quickly fast.

1. Assume a husband owns an IRA in a community property state. One-half of the husband's IRA is recognized as owned by his wife. The wife transfers 'her half' of the IRA to an IRA in her own name, relying on her husband's durable power of attorney. That transfer is taxed as a distribution to the husband of the transferred one-half of the IRA. [Private Letter Ruling 1999-37055.]
2. A husband dies owning an IRA in a community property jurisdiction. The husband named a child from a prior marriage as the designated beneficiary of his IRA. The husband's IRA is transferred to his widow via probate court proceedings, in satisfaction of her 'community property rights' in the IRA. That transfer is treated as a taxable distribution to the named beneficiary of the decedent's IRA (his child from a prior marriage) and not to the decedent's surviving wife. [Private Letter Ruling 2016-23001.]
3. The husband's retirement account was paid to an alimony trust that was established for his spouse as part of a divorce property settlement, back when IRC 682 was still part of the Tax Code. The husband was taxed on that transfer, even

though IRC 682 would have shifted that income tax burden onto the trust or the former spouse. [Private Letter Ruling [2009-23027.]

Michigan: Michigan is not a community property state. However, if spouses move to Michigan from a community property state, their community property rights are still protected. Moreover, the spouses can enter into a community property agreement by which they agree to retain the community property classification of the assets that they bring with them to Michigan, even if those community property assets are combined with common law assets. The Michigan statute provides, in part:

1. *Upon the death of the husband or the wife, ½ of the community property shall continue to belong to the surviving spouse and the other ½ shall pass in accordance with testamentary disposition by the deceased spouse, or, in the absence of testamentary disposition, then to the heirs at law and distributees of the deceased spouse in the manner provided by law, subject to the following provisions of this section.* [MCL 557.213.] Community property in a common law state can obviously bring with it some confusion.

Example: Homer and Marg lived in California for several decades. Homer worked and contributed to a 401(k) account that he later rolled over to an IRA in California when he retired. Homer and Marg later move to Michigan to escape California's high-income taxes. When they move to Michigan, Homer and Marge enter into a community property agreement in which they agree that all assets that they brought with them to Michigan, including Homer's IRA, are community property. Homer later changes the beneficiary designation on his IRA from Marg to their son Bart. Homer does not need Marg's consent to that beneficiary designation since Homer owned an IRA, not a qualified plan account, like his former 401(k) account. Homer dies a Michigan resident. Will their community property agreement be respected by a court if Marg sues to claim one-half of the IRA? If Bart takes control of Homer's IRA, does Bart hold one half of that account as a constructive trustee? What happens if Bart takes a lump sum distribution of his inherited IRA? If Marg is successful in her claim and she takes a lump sum distribution of one-half of the IRA account balance, can Marg roll it directly into her own IRA, or will she have received her half from Bart, meaning she might not have a direct rollover? Will Bart be taxed on that distribution to Marge? Who reports Homer's required minimum distribution (RMD) if he did not take it prior to his death- Bart who is the name beneficiary of Homer's IRA, or Bart and Marg, since Marg is claiming one-half of 'Homer's' IRA asserting her community property rights, but not as the named beneficiary of Homer's IRA.

Conclusion: There are good reasons to seek to classify property as community property, principally because community property receives a 100% basis adjustment on the death of

one spouse. However, when it comes to retirement assets and the income taxation of distributions from retirement assets [or entitlement to the income tax credit for federal estate taxes paid on the decedent's retirement assets under IRC 691] there can be lots of questions that will need to be addressed thanks to the unusual community property rules, even in a common law jurisdiction like Michigan which respects community property within its jurisdiction.