DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
July 6, 1999

CC:EBEO:7
[redacted]

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Chief, Branch 7
Office of Associate Chief Counsel (EBEO) (CC:EBEO:7)

SUBJECT:

This Field Service Advice responds to your request for assistance regarding certain issues arising on an examination of the above-referenced taxpayer. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

TP1 =
TP2 =
Entity A =
IRA A =
Court X =
State Z =
a =
b =
c =
d =
e =
f =
g =
q =
r =
s =

w =
x =
y =
z =

ISSUES

1. Whether the Service should issue a "protective" statutory notice of deficiency against TP2 pursuant to IRC §408(d)(6) to avoid potential "whipsaw" where TP1 received a distribution from IRA A and transferred the funds to TP2 before a marital settlement agreement was executed and before a divorce decree was entered.

2. Whether the Service should issue a "protective" statutory notice of deficiency against TP2 pursuant to IRC §408(d)(1) to avoid potential "whipsaw" where TP1 and TP2 reside in a community property state, TP1 received a distribution from IRA A and transferred the funds to TP2 before a marital settlement agreement was executed and before a divorce decree was entered.

FACTS

On w, TP1 and TP2 were married. On x, TP1 established IRA A with Entity A. TP1 claims that he established IRA A with real estate brokerage income which he received during his marriage to TP2. It appears that IRA A may be part of a simplified employee pension ("SEP"), as described IRC §408(k). Under the terms of IRA A, TP1 is the owner and annuitant, and TP2 is one of two named beneficiaries.

By check dated y, TP1 received a single-sum distribution from IRA A in the amount of $q. TP1 immediately endorsed the check over to TP2. TP2 deposited the check into her personal account and, subsequently, used the money (or a portion thereof) to pay various expenses, including attorneys fees, a $r encumbrance on residential property, credit card debts, and medical bills. TP2 also gave $s to TP1.

On z, nineteen days after y, TP1 and TP2 executed a Stipulation for Judgment and Marital Settlement Agreement ("Agreement"). Thirty-one days later (i.e., 50 days after y), on a, the Agreement was filed with Court X, and thereafter included in a judgment of dissolution of marriage on b, approximately 7 months after y. Paragraph c of the Agreement provided as follows:

> "Husband's interest in the separate property IRA [A] with [Entity A] shall be transferred to the respondent [TP2], and thereafter will be her sole and separate property."

Paragraph c, as provided above, was initially drafted by TP1's attorney, as follows:

> "Husband's interest in his SEP IRA [A] with [Entity A] shall be transferred to an IRA in Wife's name alone, and will thereafter be her sole and separate property."... "Wife understands that the transfer of the funds from Husband's IRA to an IRA in her name is, in and of itself, intended to be a nontaxable event. However, the withdrawal of funds from Wife's IRA account will be subject to State and Federal Taxes as well as a penalty for early withdrawal."

TP1, through his attorney, claims that the parties had agreed to, and a judge had orally approved, the Agreement before TP1 received the check from Entity A. However, TP1 has not submitted any documentation or oral testimony supporting this claim.

We understand that TP2's attorney has indicated that his client flatly rejected the original version of paragraph c of the Agreement which placed the tax consequences of IRA A on TP2. He has also indicated that paragraph c was changed because TP1 had already received a distribution from IRA A, and the Agreement was intended to reflect the parties understanding that TP1 would bear the tax consequences of the IRA A distribution. Further, he indicated that the references to IRA A in the adopted version of Paragraph c were intended only to reflect the source of the funds transferred to TP2.

We understand that TP1 and TP2 reside in State Z, a community property state. TP1 was born on d, and TP2 was born on e. We also understand that the statute of limitations for TP1 expires in f, and that the statute of limitations for TP2 expires in g.

Specifically, your office has requested advice regarding whether the Service should issue a "protective" statutory notice of deficiency against TP2 pursuant to IRC §408(d)(6) to avoid potential "whipsaw" under these circumstances.

LAW

IRC §408(d)(1) provides as follows:

> "Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72."

IRC §408(d)(6) provides as follows:

> "The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of such transfer is to be treated as an individual retirement account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse."

IRC §408(g) provides as follows:

> "This section shall be applied without regard to any community property laws."

IRC §71(b)(2) provides as follows:

> "The term "divorce or separation instrument" means (A) a decree of divorce or separate maintenance or a written instrument incident to such decree, (B) a written separation agreement, or (C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse."

DISCUSSION

IRC §408(d)(1) provides, in general, that any amount paid or distributed out of an IRA shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under IRC §72. However, an exception to IRC §408(d)(1) under IRC §408(d)(6) provides that a transfer of an IRA made under a divorce or separation instrument described in IRC §71(b)(2)(A) is not treated as paid or distributed for purposes of IRC §408(d). IRC §71(b)(2)(A) defines a divorce or separation instrument as a court decree or written instrument incident to a divorce or separation. Accordingly, IRC §408(d)(6) applies only to a transfer of an IRA under a court decree or a written instrument incident to a divorce or separation.

A case involving the tax treatment of a transfer of an IRA in connection with a separation or divorce is similar to cases involving the tax treatment of a distribution of qualified plan benefits under a qualified domestic relations order ("QDRO") as described under IRC §414(p) because both types of cases address whether the distribution or transfer occurred under a written instrument or decree.[1] In this case, the distribution of the IRA assets occurred on y, and the written Agreement was executed on z, 19 days later. Thirty-one days after z (i.e., 50 days after y), the Agreement was filed with Court X. In similar circumstances involving QDROs, the Tax Court has held that a distribution cannot be made under a written instrument when the distribution occurred before the written instrument was executed. Burton v. Commissioner, T.C.Memo. 1997-20 (before QDRO was executed, taxpayer received and transferred to his former wife amounts distributed from his qualified plan for purposes of satisfying a mortgage; Tax Court stated that "since the plan proceeds were distributed to petitioner and not to Mrs. Burton [the former spouse], and in advance of the Decree, it cannot be argued that the distribution was made by the plan administrator to an alternate payee in response to the Decree."); See also Rodoni v. Commissioner, 105 T.C. 29 (1995).

In this case, based on the facts as we understand them, there was no written instrument or decree in existence on y, the date on which the distribution from IRA A was made to TP1. In addition, because TP1's attorney has not submitted any oral or written testimony to support the existence of any such written instrument or decree, it does not appear that the IRA A distribution at issue in this case was made under a written instrument incident to separation or divorce, or a court decree. However, [redacted].

In addition, IRC §408(d)(1) provides that any amount paid or distributed out of an IRA is included in gross income by the payee or distributee, as the case may be, in the manner provided under IRC §72. The terms "distributee" or "payee" are

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[1]IRC §402(e)(1)(A) provides that, for purposes of IRC §402(a) and IRC §72, an alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order (as defined in IRC §414(p)).

not defined in the Code or Treasury Regulations. In general, a distributee is the participant or beneficiary who, under the plan, is entitled to receive the distribution. See Darby v. Commissioner, 97 T.C. 51 (1991) and Powell v. Commissioner, 101 T.C. 489 (1993). Since TP1 received the IRA A distribution, TP1 is also the "payee." Accordingly, in this case, we believe that TP1 is the distributee and payee of the distribution from IRA A.

However, it appears from the facts discussed above that IRA A was established while TP1 and TP2 were married, and that TP1 and TP2 reside in a community property state. In general, assets accumulated during the course of the marriage in a community property state are community property and, depending on state law, each spouse may be considered to own a one-half interest in such property.

Under the general rule of statutory construction, federal statutes are construed in a manner that does not preempt State law, particularly domestic relations laws, unless preemption was the clear and manifest intent of Congress. Mansell v. Mansell, 490 U.S. 581, 587 (1989)(military retirement pay and veterans disabilty benefits); McCarty v. McCarty, 453 U.S. 210 (1981)(military retirement pay). In general, state law determines property interests and federal tax law determines the tax consequences attributable to such interests. Thus, we must consider whether IRC §408(g), which provides that IRC §408 applies without regard to any community property laws, has the effect of insulating TP2 from taxability.

In Boggs v. Boggs, 520 U.S. 833 (1997), the Supreme Court held that state community property law is preempted by the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by the Retirement Equity Act of 1982 ("REA"), because, under ERISA, Congress specifically designed a scheme prescribing how and to whom retirement benefits are required to be provided, including applicable exceptions thereto. Boggs did involve, in part, the disposition of IRA assets that were attributable to a rollover contribution from a qualified plan. However, it is unclear whether the Supreme Court's holding in Boggs would affect the disposition of this case.[2]

The Tax Court has held in a pre-REA, pre-Boggs case involving qualified plan benefits that, under state community property law, both the husband and the wife can be treated as distributees as to their respective one-half share interests

[2] 29 C.F.R. §2510.3-2(d) excludes IRAs described in IRC §§408(a) and (b) from ERISA coverage if certain requirements are satisfied. 29 C.F.R. §2510.3-3(b) generally excludes plans without employees from ERISA coverage (e.g., an individual who wholly owns a trade or business is not an employee with respect to that trade or business).

under a plan. Powell v. Commissioner, 101 T.C. at 497-498. [redacted]

[3] IRC §402, which provides the rules governing the taxation of qualified and nonqualified plan distributions, does not include a provision similar to IRC §408(g) expressly providing that the section shall be applied without regard to community property law. However, as stated above, state community property law is preempted by the statutory scheme established by federal law under ERISA for distributions from qualified plans. Boggs v. Boggs, 520 U.S. 833 (1997).

If you have any further questions, please call me at (202) 622-6090.

By: ______________________________

MICHAEL ROACH
Chief, Branch 7