Bunney v. Commissioner of Internal Revenue, 114 T. C. 259 (2000)

In community property states, IRA distributions are taxable to the IRA participant, not the nonparticipant spouse, despite community property interests.

Summary

In Bunney v. Commissioner, the U. S. Tax Court ruled on the tax implications of IRA distributions in a community property state. Michael Bunney, post-divorce, withdrew funds from his IRA and transferred part to his ex-wife. The court held that under IRC section 408(g), Bunney was taxable on the entire distribution, as his ex-wife's community property interest did not make her a "distributee. " The court also upheld the 10% additional tax on early distributions and found Bunney liable for a negligence penalty on conceded items, but not on the contested IRA issue due to its novelty.

Facts

Michael Bunney and his former wife were divorced in California, a community property state, in 1992. The divorce decree ordered Bunney's IRA, funded with community property, to be divided equally. In 1993, Bunney withdrew $125,000 from his IRA, transferred $111,600 to his ex-wife, and reported only $13,400 on his taxes, claiming the rest was not taxable due to his ex-wife's community property interest.

Procedural History

Bunney petitioned the U. S. Tax Court to redetermine a $84,080 tax deficiency and a $16,816 negligence penalty for 1993. The case was submitted fully stipulated. The court's decision addressed the taxability of IRA distributions, the applicability of the early distribution penalty, and the negligence penalty.

Issue(s)

1. Whether Bunney's gross income includes the entire $125,000 in IRA distributions?
2. Whether Bunney is subject to the 10% additional tax for early distributions under IRC section 72(t)?
3. Whether Bunney is liable for the negligence accuracy-related penalty?

Holding

1. Yes, because IRC section 408(g) precludes recognition of the nonparticipant spouse's community property interest in allocating the taxability of IRA distributions.
2. Yes, because Bunney did not meet any of the exceptions to the early distribution penalty under IRC section 72(t)(2)(A).

3. Yes, for the conceded items, because Bunney's errors were due to negligence. No, for the contested IRA issue, because Bunney had a reasonable basis for his position.

Court's Reasoning

The court applied IRC section 408(d)(1), which taxes IRA distributions to the "payee or distributee," defined as the participant or beneficiary entitled to receive the distribution. The court rejected Bunney's argument that his ex-wife's community property interest made her a distributee, citing IRC section 408(g), which requires section 408 to be applied without regard to community property laws. The court reasoned that recognizing community property interests would conflict with IRA qualifications, rollover rules, minimum distribution requirements, and the balance between sections 219(f)(2) and 408(g). The court found Bunney's position on the IRA issue to be arguable, thus precluding the negligence penalty for that portion, but upheld the penalty for other errors due to Bunney's lack of reasonable cause.

Practical Implications

This decision clarifies that in community property states, IRA distributions are taxable to the IRA participant, regardless of the nonparticipant spouse's property interest. Practitioners must advise clients that transferring IRA funds directly to a spouse post-distribution does not avoid taxation. The ruling may affect divorce settlements involving IRA division, as the tax burden remains with the participant. Subsequent cases like Czepiel v. Commissioner have followed this ruling. Practitioners should be aware of the potential for reasonable basis defenses in novel tax issues to avoid negligence penalties.