Community Property Trusts

December 18, 2023

Take-Away: Some states now offer the use of a community property trust, even for nonresidents. While the tax savings using a community property trust can be extraordinary, there are still some risks in their use.

Background: Some states are now willing, if not eager, to change their laws to attract married couples to move their wealth to their states. Welcome to Florida! Such law changes permit a married couple to opt for community property treatment of their assets. Historically, only 9 states, based on civil law principles, adopted a community property regime for married individuals. In these 9 states the law presumed that both spouses share an undivided interest in all assets that are earned or acquired by them during their marriage, regardless of who earned the asset or whose name appears as the asset's owner.

IRC 1014(b)(f): What is significant is that in community property states a married couple can potentially receive what is often called a *double basis step-up,* that results in substantial tax savings. [IRC 1014(b)(6).]

> Community Property: When a married couple live in a community property state and the couple acquires an asset during their marriage, both marriage partners share an 'undivided interest' in that asset for as long as they are married. When one of the spouses dies, the community property regime then authorizes an income tax basis step-up over the entire community property asset, thus leading to the term "double basis step-up." This increase in the asset's tax basis to its fair market value effectively reduces (or possibly eliminates) the capital gains tax that the surviving spouse will incur when he/she ultimately sells that community property asset.
>
> Common Law Property: In a common law jurisdiction like Michigan, by contrast, if the marriage partners own their assets as tenants-by-the-entireties, or as joint tenants with full rights of survivorship, when one

spouse dies, each spouse is attributed one-half of the asset's value at the time of the first spouse's death. Consequently, only one-half of the jointly owned asset qualifies for an income tax basis step-up on one spouse's death.

Example: Betty and Barney own their home as tenants-by-the-entireties. Betty and Barney file joint income tax returns as a married couple. They purchased their home years ago for $200,000. Today, the fair market value of their home is $600,000. Barney dies. After Barney's death Betty decides to sell the home, downsize, and move to a more manageable condominium. Betty sells the home after Barney's death for $600,000.

Michigan: If Betty and Barney live in Michigan, a common law jurisdiction, Betty's income tax basis in the home will be $400,000. [Initial purchase price of $200,000 + 50% of the $400,000 of gain, or another $200,000 = $400,000. Thus, when Betty sells the home for $600,000 she will recognize $200,000 gain. Fortunately for Betty, she and Barney had lived in the home for more than 5 years, so that Betty can use her IRC 121 exclusion of $250,000 from the gain that results from the sale of her principal residence to avoid paying any capital gain. However, if the jointly owned real property was vacant hunting land and not a principal residence, then the IRC 121 exclusion of $250,000 gain would not be available to Betty and she would pay capital gains tax on the full $200,000 that she recognized.

California: If Betty and Barney live in California, a community property jurisdiction Same facts as above. Betty calculates her income tax basis in the home of $600,000 at the time of its sale. The entire home value, not just 50% of it, receives a step-up in income tax basis to its fair market value. Consequently, the California home's income tax basis matches the $600,000 fair market value, and Betty will incur no capital gains on the home's sale, nor will she have to comply with some of the technical requirements of IRC 121 to avoid recognizing capital gains tax liability on the sale of her principal residence. This example represents the power of the "double basis step-up" in a community property jurisdiction.

Community Property Trust: A handful of common law states have in recent years adopted statutes that permit a married couple to elect to adhere to community property principles and thus intentionally choose to override the default rules of some, or all, of the jointly held assets in that common law jurisdiction. Those states are Alaska, Florida, Kentucky, South Dakota, and Tennessee. Florida enacted its version of a community property trust in 2022 with the clear intent of attracting married couples to move their investment portfolios to Florida to gain a "double basis step-up" with the use of an elective community property trust.

Florida: If the married couple transfer the title to their common law assets to a community property trust, like Florida, and one of the spouse's then dies, *all* of the assets titled in the name of the community property trust will receive an income tax basis adjustment equal to their fair market value as to the date of the one spouse's death, i.e. a 100% income tax basis step-up when one spouse dies. This, then, permits the surviving spouse to sell the community trust assets after his or her spouse's death and not pay much, if any, capital gains tax.

Michigan: While for several years now a community property trust Bill has been proposed in Michigan's Legislature. However, neither it nor the separately proposed entireties trust Bill has gotten much traction. Apparently the Michigan Bankers Association has reservations with each of these Bills. Thus, it is unclear if Michigan will ever get around to adopting an elective community property trust regime to enable spouses to exploit the "double basis step-up" that other community property states, or the electing handful of common law states that have made available to married couples in their own states or who reside in other states.

Tennessee Tennessee's 2010 community property trust statute, as an example, imposes the following requirements:

1. Both spouses must be settlors of the trust;

2. The trustee must be a qualified Tennessee trust company, bank, or resident, including either or both spouses who reside in Tennessee;

3. The trust must divide assets equally if the settlors divorce, or the trust must include terms that address the division of the trust's assets in the event of their future divorce;

4. The trust is subject to creditor claims, but only one-half of the trust assets are subject to such spouse's creditors; and

5. The settlors must be able to distribute or remove trust assets at any time and if so, such 'removed' assets will no longer be treated as community property.

Community Trust Risks: While transferring marital assets to an elective community property trust to gain a full income tax basis adjustment on the death of one spouse sounds like a great tax planning strategy to pursue, there are some potential drawbacks to the use of a community property trust that must first be considered.

> Divorce: The married couple with their trust may create a presumption that each community property asset is to be divided equally during their marriage and upon their divorce. In contrast, in a common law jurisdiction like Michigan, an equitable division of marital assets would guide the divorce judge, and *separate* property that one spouse brought into the marriage or that was received by one spouse during the marriage by gift or inheritance would as least preliminarily retain its *separate* property character to be returned by the divorce court to the donee-inheritor of that *separate* property. [Jeff Bezos and his wife lived in Washington at the time of their divorce, a community property state, which means that 'their' Amazon stock had to be divided 50%-50% in their divorce. That might explain, at least in part, why Jeff has now moved from Seattle to Miami, a common law jurisdiction.]

Creditor Exposure: In Michigan, if the married couple own their property as tenants-by-the-entireties, there is creditor protection when the judgment creditor's claim is against only one spouse. The entireties owned asset is not subject to a forced-sale by the judgement creditor of one spouse to gain access to the equity in the entireties owned asset to satisfy their judgment. That creditor protection would be lost by converting that tenants-by-the-entireties asset to a community property trust in most states.

Loss of Control: If it is important for one spouse to control the disposition of a particular asset, characterizing it as community property in this type of elective community property trust, even if the asset were held in the sole name of that one spouse, would cede disposition control over one-half of the asset to the other spouse.

IRS: The IRS has not formally commented on or taken an official position on the 'election' by spouses to choose to have their common law assets be treated as community property. [IRS Publication *Community Property*, 2020.] Arguably, there is the risk that that IRS could oppose the full income tax basis adjustment of assets held in a community property trust in a common law state.

Tax Court: There does, however, seem to be some old judicial support for a full income tax basis adjustment of community property assets held in a common law state. In *McCollum v. United States,* 58-2, Tax Court No. 9957, Northern District of Oklahoma (1958) a married couple elected to treat property as community property under Oklahoma's then in existence 'opt-in' community property law. The Tax Court held that "local law…property rights are determinative for tax purposes" and that the property was considered community property from the time of the original election and therefore a full income basis step-up was applied. However, it is important to note that the Tax Court included in its analysis a reference to a change in the community property laws that occurred *after* the spousal election but before the decedent's death, which caused marital property to

be treated as community property. See also *Westerdahl v. Commissioner,* Westerdahl v Commissioner, 82 Tax Court 83 (1984) and *Angerhofer v. Commissioner,* 87 Tax Court 814 (1986)

State Law Controls: And in a 1993 IRS *Field Service Advisory,* which addressed the treatment of community property that was brought into a common law property state, the IRS noted that "the controlling factor is the characterization of the property under state law" and it concluded that property under Oregon law (a common law property state) would retain its community property classification and a surviving spouse would, thus have a fair market value basis in the entire asset on her spouse's death. [1993 WL 1609164, November 24, 1993.]

Comment: If a state incorporates characteristics of the community property statutes from the 8, now 9, original community property jurisdictions in its community property trust legislation, it should be respected by the IRS, or at least by the Tax Court if the IRS challenges a taxpayer's elective classification of the assets held in the trust as being community property in nature.

Conclusion: The states that have adopted community property trust legislation are beginning to aggressively market them to out-of-state common law citizens as a sophisticated tax-savings strategy. Consequently, you can expect to start to field some questions from married clients on whether they are 'good candidates' to move some of their marital assets into a community property trust for tax basis planning purposes. While there is still some question (and in a couple of commentators' views, 'concerns') that the IRS will agree with a 100% income tax basis step-up when one spouse dies owning an elective interest in a community property trust, that may well be a risk worth taking in light of the tax savings to be achieved. Probably the greater risks associated with the use of a community property trust is a future divorce of its settlors, or judgment creditor claims against one spouse which could have been avoided if the assets had been held as tenants-by-the-entireties.