Community Property Trusts

Take-Away: For married individuals who want to plan for a basis adjustment on death, consider the potential use of a community property trust that is now available in 5 states (but not Michigan.)

Background: As was previously mentioned in these missives, there seems to be a major shift in estate planning these days, away from the avoidance of federal estate taxes with a $15 million transfer tax exemption per individual coupled with portability of the decedent's unused exemption amount, and towards saving capital gain taxes after the death of a married individual. [IRC 1014.] One way to avoid capital gain taxes is for spouses to own their property as community property, and perhaps in a community property trust.

Community Property and Basis: The Tax Code applies a 100% basis adjustment (step-up) on the death of one spouse if the asset is held by spouses in a community property jurisdiction. [IRC 1014(b)(6).] This 100% basis adjustment contrasts with a spouse's death in a common law jurisdiction, like Michigan, where assets held jointly by spouses receive only a 50% income tax basis adjustment on the death of one spouse. [IRC 20240(b).] This Tax Code section expands the definition of *property acquired from the decedent* to include the surviving spouse's one-half interest in the community property, if at least one-half of the whole is included in the decedent's gross estate. [IRC 1014(b)(6).] Moreover, this Tax Code section does not define community property; rather, it presumes the existence of a state law community property regime. Consequently, there is a big tax advantage regarding tax basis adjustments on the death of one spouse if the marital couple reside in a community property state.

Adjustment on Death: The United States Supreme Court has held that marital property characterization follows state law ownership rights, even when the property is located outside the state whose law creates those rights. [*Morgan v. Commissioner, 309 U.S. 78 (1940.)*] The IRS agrees that federal tax consequences follow state law marital property characterization. [Revenue Ruling, 87-98; Private Letter Rulings 200101021 and 20021005.] The U.S. Tax Court has affirmed that community property characterization will be respected by federal court when state law treats the spouses' interests as community property, even if that asset was not located in a traditional community property state. [*McCollum v. United States, 58-2 Tax Court, 1958.*] This brief history may explain why several common law states have now enacted community property trust statutes that enable spouses who create these unique trusts to enjoy a full basis step-up (or down) to fair market value on one spouse's death.

Michigan: A couple of years ago a bill was introduced in Michigan's Legislature to adopt a community property trust, but that bill went nowhere. As this missive is written, this 'old' bill was never reintroduced. [Which makes you wonder what exactly those folks in Lansing are doing with their time, other than apparently perpetually running for office.]

Opt-in Community Property Trusts: In recent years five states have adopted opt-in community property trust statutes that permit spouses to elect to have the community property trust assets to be treated, and taxed, as community property. Those state are Alaska, Tennessee, Kentucky, South Dakota, and Florida. Ohio is currently considering the adoption of a similar community property trust statute. Some common features of these five state statutes include:

- **Signed Election Required:** Each state statute requires an affirmative election for the community property treatment that is signed by both spouses.
- **Notice or Warning Required:** Each state requires some type of conspicuous notice or warning regarding the consequences of the community property arrangement, such as with respect to creditor claims against the trust assets or a later divorce between the spouses. These notice requirements differ from state-to-state regarding contents of the Notice.
- **Resident Trustee Required:** Each state requires some type of qualifying resident trustee, so that the community property trust is administered in that state. In the case of Florida, it has presumably the least restrictive requirement since a resident individual or a corporate trustee authorized to act in Florida can serve as the trustee of the community property trust.
- **Creditor Rights Against the Trust:** These adopting states differ when it comes to creditor rights enforced against the trust. Florida's statute clearly provides that the debt of one spouse can be satisfied with 50% of the trust's assets. In contrast, both Alaska and South Dakota's statutes do not prescribe that a creditor of one spouse can access one half of the trust assets. Instead, those statutes provide that their statute 'does not adversely affect a creditor's interest unless the creditor has actual

knowledge of the arrangement when the obligation was incurred by one spouse.' South Dakota's statute also uses fraudulent transfer principles regarding its irrevocable trust.

- **Florida- Trustee Allocation Rights:** One key feature of the Florida statute that may make it more 'protective' against creditor claims against one spouse is that the trustee possesses the ability to determine how assets are allocated between the spouses' one-half shares if certain events occur. Accordingly, the trustee could allocate to the debtor-spouse's one-half interest in the trust assets that might be problematic to seize and liquidate by the creditor, e.g., an LLC interest subject to an exclusive assignee interest, or life insurance which is protected under another creditor exemption statute.
- **Situs of Assets:** Each state's statute is broadly drafted so that there does not appear to be any limit on the type of asset contributed to the community property trust. In other words, the trust's assets are not restricted to being in the state where the community property trust is administered.
- **Example:** A Michigan married couple who own a condo in Naples, Florida could execute a Florida community property trust and title their Michigan cottage in that trust. The Michigan cottage will receive a 100% basis adjustment on the death of one spouse if the community property trust instrument states that 'all trust assets, wherever located, are community property during our marriage.'

Conclusion: The opportunity of a married couple to ensure that all of their trust-owned assets will receive a 100% basis adjustment on the death of one spouse is an attractive planning technique, especially now that the emphasis of much of estate planning has shifted from transfer tax minimization to income tax savings by the surviving spouse (or the couple's heirs.) The marriage partners will need to be made aware of the negative consequences of an opt-in community property trust, such as the loss of separate property claims in a future divorce, or the exposure of some trust assets to creditor claims against one spouse (unlike entireties owned property), or the probable hostility that the IRS will undoubtedly have with an election to gain a full basis step-up on the death of one spouse, but those risks may well be worth taking. It's yet another topic to raise when counseling a married couple about their estate planning needs.

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