COMMUNITY PROPERTY IN OREGON

ADVISING COUPLES TRANSITIONING FROM A COMMUNITY PROPERTY STATE TO OREGON

Presenters:

William D. Brewer
Nicholas M. Frost

Hershner Hunter LLP

Eugene-Springfield Tax Association, April 30, 2013

HERSHNER HUNTER LLP

ATTORNEYS 180 East 11th Avenue, Eugene, Oregon 97401 PO Box 1475, Eugene, Oregon 97440 **541-686-8511** fax 541-344-2025

COMMUNITY PROPERTY IN OREGON

Bill Brewer & Nick Frost
Hershner Hunter LLP
Eugene, Oregon

TABLE OF CONTENTS:

Page

PRESENTER BIOS

William D. (Bill) Brewer. Bill is an estate planning partner in the Hershner Hunter law firm in Eugene, Oregon. Bill is a Fellow of the American College of Trust and Estate Counsel (ACTEC), and has been selected by his peers for inclusion in Best Lawyers in America. He is a contributing author to the Oregon State Bar publication *Administering Oregon Estates* and to Steve Alberty's treatise, *Advising Small Businesses*. He served on the Oregon State Bar's Estate Planning and Administration Executive Committee for nine years and is a past president of the Eugene Estate Planning Council, and past officer of the Lane County Bar's probate section.

Nicholas M. (Nick) Frost. Nick is an associate with Hershner Hunter LLP, in Eugene, and practices in the fields of estate planning, business formation and succession planning, and trust and estate administration. He received his B.A. from the University of Michigan in 2003, and his J.D., *cum laude*, from the University of Michigan in 2006. He has taught as an adjunct professor at the University of Oregon Law School and has co-authored chapters in *Administering Oregon Estates* and *Advising Small Businesses*. He is a member of the Illinois State Bar Association since 2006, and the Oregon State Bar since 2010.

I. INTRODUCTION

From the broadest view, the phrase "community property" suggests one way in which people can own property, just as they might own property, for example, as joint owners, tenants-in-common, or with a right of survivorship. Community property is limited to ownership of an asset by a married couple (similar to how a tenancy-by-the-entirety can only be created by a married couple). Thus, a couple might own a piece of real property, or a brokerage account, or a dining room table, "as community property." The ways in which assets may be owned are not necessarily exclusive of one another, but each carries with it its own limitations or extensions of the property rights of the owner with respect to the property.

The ability to own a marital asset as community property is a matter of state law. Most states, including Oregon, do not permit acquisition of assets as community property. However, all of Oregon's neighboring states do permit the ownership of marital assets as community property. This proximity to community property states means that advisors in Oregon need to be familiar with the characteristics and importance of community property. For clients who own community property, there are some potentially significant tax advantages that should not go ignored, and significant tax liabilities could result from unintentionally destroying the community property nature of assets.

II. CHARACTERISTICS OF COMMUNITY PROPERTY

A. What Assets Are Community Property?

Assets acquired by a married couple during marriage while living in a community property state are community property. There are exceptions for gifts or inheritances received by a single spouse. The separate property of each spouse that is brought into the marriage remains separate property. Generally, proceeds of separate property are separate property, and proceeds of community property are community property. Commingling of separate and community property can affect the nature of such property.

Although at a basic level all community property states follow somewhat similar rules, individual states vary on such issues as whether income from separate property is community property or separate property; whether life insurance is community property or separate, depending on the source of the premium payments; and to what extent community property is subject to the debts of one member of the couple. Delving into these differences is beyond the scope of this outline.

If a married couple moves from a community property state to a common law state, earned income and assets acquired with that income after the move are not community property. If a married couple moves from a common law state to a community property state, earned income and assets acquired with that income after the move are community property. The treatment of assets already held by the couple prior to moving states is the focus of these materials.

B. Basic Distinction of Community Property: Vested Property Right At Acquisition

Under community property rules, all assets acquired by a married couple during a marriage, other than through gift or inheritance, belong to both spouses as equal undivided interests. These rights are vested in each spouse at the time the asset is acquired. The vesting occurs even if title is held in the name of just one spouse. In other words, taking title in the name of one spouse does not override the community property nature of an asset.

Compare that immediate vesting with the situation in a traditional common law marital property state like Oregon. In common law marital property states, the rights to property acquired in the name of one spouse during a marriage may ultimately be divided between the spouses, but such property right for the spouse who is not the owner of record does not become vested until the right is determined by a court in a dissolution action; or at death, through inheritance or by application of an elective share action. The spouse who is not the owner of record does not have a vested property right at the time of the acquisition of the asset.

C. Community Property States

Oregon is surrounded by traditional community property states, including Washington, Idaho, Nevada, and California. Other traditional community property states include Arizona, New Mexico, Texas and Louisiana. In 1986 Wisconsin became a community property state by adopting the Uniform Marital Property Act. See Wisc Stat §766.001 et seq.

Alaska and Tennessee have also adopted their own versions of the Uniform Marital Property Act as an “opt in” regime that allows a couple to choose between community property and traditional common law approach to marital property. Alaska allows a nonresident couple to choose community property by setting up a trust with an Alaska resident trustee to make the trust assets community property. Alaska Stat §34.77.10 et seq. Tennessee has a similar structure permitting couples to create a community property trust for certain assets. Tenn Code Ann §35-17-101, et. seq.

As mentioned above, the laws of each community property state vary on some of the finer points, though the larger concepts discussed in this outline remain applicable for community property wherever it is located.

D. Emigration from Community Property States

What happens to a couple’s community property acquired during marriage when the couple moves from a community property state to a common law marital property state like Oregon? The brief answer is that it does not automatically lose its community property characteristics simply as a result of the move.

Section 1 of the 14th Amendment to the Constitution provides in part “nor shall any State deprive any person of life, liberty, or property, without due process of law” A move across state lines cannot deprive a spouse of the vested property rights the spouse has under the laws of community property because there would be no due process to cause the change.

Similarly, under basic conflict of laws principles a right belonging to either or both spouses in property is not affected by a change in domicile by the couple to a different state. Restatement (Second) Conflict of Laws §259.

Oregon law clearly anticipates the potential that couples moving to Oregon are entitled to retain any community property rights they bring with them to Oregon. See the Uniform Disposition of Community Property Rights at Death Act, ORS §112.705 et seq. See also ORS §130.505(2)(a), describing the requirements to revoke a community property trust.

However, while Oregon allows couples to keep marital assets as community property, a couple might still unintentionally jeopardize the community property nature of the assets if they are not careful. Financial and legal advisors need to be prepared to advise clients on actions to take to protect the community property status of property.

III. WHY COMMUNITY PROPERTY MATTERS

A. Tax Benefits of Community Property

Before discussing the process for protecting community property assets, it is important to discuss why advisors should care whether assets are community property at all. Community property offers some tax benefits not available in a common law marital property state like Oregon. These benefits include at least the following:

- *New Basis At Death for Surviving Spouse's Interest.* The major reason we care about community property is that at the death of the first spouse, the surviving spouse's half of the community property gets a new basis in addition to the new basis given to the decedent spouse's half of the community property. IRC §1014(b)(6).

- *Valuation Discount*. Community property is not subject to IRC §2040, which states that the value of certain jointly-owned property is strictly decedent's percentage interest without any discount. <u>Propstra v. U.S.</u>, 680 F.2d 1248 (9th Cir. 1982). If a decedent's one-half joint-ownership interest in a piece of real property is common law property and §2040 applies, it will simply be valued at 50% of the total value of the real property. If instead the decedent's one-half interest is community property, a fractional interest discount can be applied.

- *Spouses As LLC Members.* A couple operating under community property law can form an LLC as a disregarded entity with both spouses being members of the LLC. Under a common law marital property regime like Oregon's, generally if both spouses are members of one LLC, the LLC is treated for tax purposes as a partnership and not as a disregarded entity. Rev Proc 2002-69.

- *Gift-Splitting.* A couple operating under community property law can make a gift and get automatic gift splitting without having to file a gift tax return. See Instructions for IRS Form 709, page 1, which states that "You must file a gift tax return to split gifts with your spouse," but notes that "If a gift is of community property, it is considered made one-half by each spouse." Therefore, if one member of the couple in a community property state gives a child $28,000 in 2013, the gift is automatically within the annual exclusion because the gift is treated for gift tax purposes as from both spouses, even if it is a check drawn on an account in just one spouse's name. However, some community property states prohibit such a gift without the written consent of the other spouse. See Cal Fam Code §1100(b).

B. Advantages of New Basis

It is difficult to overstate the potential benefit of the readjusted basis for both the decedent and the surviving spouse's community property. For example, if a brokerage account with 5,000 highly appreciated shares of Company X is held as community property of both husband and wife, and husband passes away, husband's 2,500 shares get a new basis as of the date of his death, but so do surviving wife's 2,500 shares. The obvious initial impact is that a sale of surviving wife's shares at that time would no longer recognize any gain. However, there are many other planning opportunities to consider.

- An investment portfolio with highly concentrated positions can be rebalanced without concern for recognizing gain. In the above example, the surviving spouse can sell some or all of the 5,000 shares held in Company X and diversify his or her investment portfolio.

- A credit shelter trust can be funded with both the decedent and the surviving spouse's interests in an asset, such as a jointly-owned brokerage account, without recognizing gain. Using the example, if the 5,000 shares in the joint brokerage account were not community property, only decedent's 2,500 shares could be used to fund a credit shelter trust without recognizing gain. If the surviving spouse also wanted to fund the credit shelter trust with surviving spouse's non-community property 2,500 shares, he or she would exchange the shares for other property of decedent, and the exchange would cause recognition of any gain. With community property, mechanically the same exchange occurs, but there is no gain to consider.

- The double basis change also applies with respect to the basis adjustment under IRC §743 for a partnership that has made the election under IRC §754 in which one spouse is a partner, if the spouse's interest is community property. Rev Rul 79-124.

Note that the underlying assumption whenever basis readjustment comes into play is that the basis will be "stepped up" as a result of the first death. However, as events in 2007 through early 2009 proved, the new basis at death can also be a "step down," which should be considered when determining community property status. Also, preserving community property may not be as important for couples whose primary assets will not benefit from a new basis, such as an IRA, certificates of deposit, or a home that fits within IRC §121's gain exclusion (which may be up to $500,000 for the surviving spouse if the sale is within two years of decedent spouse's death). IRC §121(b)(4).

Nevertheless, the impact of acquiring a new basis for the entire community property of both a decedent spouse and the surviving spouse has the potential to be hugely significant to a couple with highly appreciated assets. Failure to recognize and take advantage of it could be a major lost opportunity for an advisor.

IV. PRESERVING COMMUNITY PROPERTY

A common event for estate planners in Oregon is to meet with a retired married couple that moved here from California, and who have previously put all their assets into a California community property joint trust. The use of trusts is far more common in California than in most other states because of the time and expense of conducting a probate in California. Often the couple will have purchased a home and opened bank and brokerage accounts in Oregon without having their assets titled in their trust.

Less commonly, a couple will move to Oregon from another community property state without a trust, but have wills and a community property agreement.

In either case, if the couple has appreciated (or appreciating) assets, the preservation of the ability to get a new basis for both halves of the community assets on the first death is likely to be a significant estate planning goal for the couple. This is even more important with the impact of recent changes in the tax code, including the 2.3% tax on unearned income, and the adoption of a 20% rate bracket on capital gains for certain taxpayers. See IRC §1411; IRC §1(h)(1)(D).

A. Approaches to Preserving Community Property

How to protect the community property rights of the couple is less clear than the importance of doing so. There is remarkably little IRS guidance on the tax consequences to a married couple that moves from a community property state to a common law state and attempts to preserve their community property rights. In fact, we have found no revenue ruling or other IRS pronouncement which clearly allows the surviving spouse the new basis on the decedent's death under IRS §1014(b)(6), when the couple moved from a community property state to a common law state with assets that should have retained their character as community property.

There is also a dearth of court rulings or cases describing successful attempts to preserve community property benefits in common law states, which is likely because the issue of whether property is, or is not, community property is irrelevant to an audit of an estate tax return. The issue will arise, if at all, as an audit issue only if the surviving spouse reports a sale of an asset that constituted the surviving spouse's half of the community property on an income tax return and uses the new basis from the date of the decedent spouse's date of death to report his or her gain on the sale. See, e.g., In re Estate of Martin, 686 N.Y.S.2d 195, 197 (NY App Div 1999), where a couple moved from California and took title as tenants by the entirety. The New York court denied the surviving spouse a new basis in her property for purposes of the New York income tax. See also United States v. Home Concrete & Supply, LLC, 132 S. Ct 1836 (2012), holding that overstating basis is not an omission of income justifying an extended statute of limitations for determining a deficiency.

Despite the lack of guidance, we believe that preserving community property in Oregon is permitted by the tax code and appropriate under Oregon law.

Notwithstanding the absence of a clear ruling on assets of a couple that has moved to a non-community property state, the IRS has at least provided a roadmap for terms required for a revocable living trust that preserves the community property characteristics of property contributed to the trust. This makes a community property trust the best option in our opinion for preserving community property in Oregon. We will discuss community property trusts in more depth below, but the following are some other ways in which couples deal with community property.

1. Sole Ownership

If a couple moves to Oregon owning as community property a brokerage account titled only in the wife's name, the husband's community property interest in that account should not be diminished when the account is moved to Oregon. Under community property rules each spouse can separately dispose of his or half of the brokerage account without having to deal with survivorship rights or elective share rights of the other. These rights should not be lost merely because of a move across state lines. However, the Oregon brokerage company or broker is not likely to recognize the husband's interest in the account if it is opened solely in the wife's name.

2. Joint Ownership and Survivorship

Holding title to assets in Oregon in the name of both spouses can cause problems for community property as well. Under Oregon law if that same couple opens an account in both names, it is likely to be opened as a joint account with survivorship features. Similarly, if they buy a house or other real property and take title in both names, the deed will create a tenancy by the entirety. ORS §93.180. Some community property states, such as California since 2001, do permit community property to be held with rights of survivorship. Cal Civ Code §682.1. However, in many community property states, owning property with rights of survivorship is incompatible with community property law. See Martin; see also Estate of Young v. Commissioner, 110 T.C. 297 (1998).

The Oregon Uniform Disposition of Community Property Rights at Death Act (the "Uniform Act") allows the surviving spouse of an Oregon couple to claim his or her interest in community property titled in the name of the decedent spouse. ORS §112.705 et seq. However, it creates a rebuttable presumption that while a couple is domiciled in a non-community property state, property titled in a manner that creates rights of survivorship is not community property. So couples moving from community property states, who subsequently title their property as husband and wife, risk unintentionally losing the protection of the Uniform Act.

In Rev Rul 68-80, the IRS held that a couple that moved to Virginia from New Mexico and took title to property as tenants in common had converted their community property to separate property. While not addressed in the ruling, it seems likely the couple took title as tenants in common as an attempt to preserve their community property on the theory that a tenancy in common was the closest common law analog to continuing to keep their community property status.

Unfortunately, in Rev Rul 68-80 the IRS did not look at what New Mexico law said it takes to convert (or "transmute") community property to separate property. Therefore, the ruling gives no guidance as to the significance of the law of the community property state with respect to the conversion of community property to separate property. California law, for instance, requires that both spouses must sign a document in order to transmute community property into separate property. Cal Fam Code §852. Merely accepting a deed titling property as tenancy in common or as tenants by the entirety would not suffice to transmute community property to separate property as a matter of California law.

Given Rev Rul 68-80, it seems risky to rely on any form of taking title which might cause the IRS to conclude that the property has been converted from community property to any form of ownership that is incompatible with community property.

3. Alternative Titling of Property.

Some Oregon practitioners have advocated that a couple moving to Oregon with community property take title to real property as "husband and wife, as community property, and not as tenants by the entirety." Another option we have seen advocated is to put the property in the name of one spouse with the added language "as community property."

The advantage of these methods of titling is that they should be sufficient to rebut any contrary presumptions under the Oregon Uniform Disposition of Community Property Rights at Death Act. However, it's not clear how a title company will react to such an attempt to title property directly as community property. The use of a community property trust complying with Rev Rul 66-283 will avoid any issues with respect to title to real property owned by the trust.

B. Community Property Trust

In Rev Rul 66-283 the IRS ruled that a revocable trust written for a California couple owning community property would allow the surviving spouse's interest in the trust to qualify for new basis under IRC §1014(b)(6). The trust had the following terms:

1. The property transferred to the trust shall retain its character as community property.

2. Husband and wife, as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part.

3. Any part of the trust estate withdrawn by any partial or complete revocation shall be transferred to husband and wife as community property.

4. The net income from the trust is community property and is to be paid to, or applied for, the benefit of both settlors.

5. On the death of the first of the spouses, the trust estate is to be divided into two equal shares, each to be administered as a separate trust.

Use of a trust complying with Rev Rul 66-283 appears to be the most appropriate way to preserve community property rights, and avoids problems with attempting to title property in the names of the couple in a common law marital property state like Oregon.

However, note that in Rev Rul 66-283, the couple remained at all times residents of California. Rev Rul 66-283 does not deal with whether that same trust would preserve community property if the couple moved to a common law marital property state. No IRS ruling that we have found deals with that specific issue.

Most of the couples we work with who have community property come from California and already have a community property trust. Usually the trust has all the elements described in Rev Rul 66-283. However, it is necessary to be sure those elements are all in the trust because to some extent practitioners in California rely on California's trust code which makes some of those provisions automatic. See, for instance, Cal Fam Code 761(b). In many cases we have to amend the trust or restate it anyway.

A typical joint trust for common law property does not work as a community property trust. A couple with Oregon non-community property does not normally own exactly half of each asset. When structuring our typical joint trust, in order to avoid having to track which spouse contributed which assets and trace their proceeds over the life of the joint trust, each spouse must make an equalizing gift of half the joint trust property to the other. These gifts need to qualify for the unlimited marital deduction to avoid being taxable gifts, and they need to be completed gifts. Also, the decedent's assets used to fund a credit shelter trust must not be includable in the survivor's estate under IRC §2036.

For these reasons, our joint trusts are structured as two trusts in one, with each spouse being the beneficial owner of half of each asset in the trust estate. Such ownership is essentially a tenancy in common and is not compatible with community property principles. Rev Rul 68-80. A complete discussion of the structure and tax issues involved in an Oregon joint trust is beyond the scope of this outline. For more information on Oregon joint trusts, see Klarquist, "Drafting joint trusts for the taxable estate," in the Oregon State Bar Elder Law Section Newsletter, January 2008.

V. SAME-SEX COUPLES

By definition, community property generally involves a married couple. However, in at least Nevada, California and Washington (before it legalized same sex marriage), registered same sex couples are entitled to claim community property rights.

A same sex couple that has community property from a state that recognizes same sex marriage or that allows community property rights for an unmarried same sex couple that registers as domestic partners should have the same rights in Oregon as a married couple. Oregon's Family Fairness Act, ORS §106.300 to §106.340, gives to registered domestic partners the same privileges, immunities, rights and benefits as are granted to married couples. Therefore, the Oregon Uniform Disposition of Community Property Rights at Death Act should apply to same-sex registered couples, and Oregon should recognize the community property rights that a same sex registered couple brings with them to Oregon to the same extent as it would for a married couple.

VI. OREGON COUPLE BUYING PROPERTY IN COMMUNITY PROPERTY STATE

What if an Oregon couple buys property in a community property state, and takes title in that state in a manner consistent with community property? The same rules from the 14th Amendment and conflicts of law mentioned earlier applies to the rights a couple acquires from being married under the laws of a common law marital property jurisdiction. If the funds used to purchase the property are separate funds, the property remains separate even though the titling is consistent with community property.

Title companies in the community property state will almost certainly treat the property as community property if the titling is appropriate for community property treatment. Under IRC §1014(b)(6), the surviving spouse's half of the property gets a new basis if the property is held by the decedent and the surviving spouse "under the community property laws of any State." So it is necessary to look at the community property laws of the state in which couple acquires the property.

Notably California Family Code §760 says in part "all property … acquired by a married person during the marriage *while domiciled in this state is community property*" (emphasis added). While Washington law does not seem to have the requirement that the couple have been domiciled in the state, case law suggests that Washington real property purchased by a buyer residing in a common law property state will not be community property. RCW §26.16.030; see Brookman v. Durkee, 90 P. 914 (Wash. 1907), holding that real property acquired in Washington with separate assets maintains its separate character.

Note that under the Oregon Uniform Disposition of Community Property Rights at Death Act, a couple residing in a community property state that purchases real property in Oregon will have the property treated as community property.

VII. INCOME TAX CONSIDERATIONS IN MULTISTATE SETTINGS

As a general rule, earnings of either spouse during marriage while residing in a community property state are community property. This can have adverse effects on couples if one spouse is deemed a resident of a different state than the other spouse. Oregon administrative rules subject

Oregon residents with a spouse residing in a community property state to income tax on the Oregon resident spouse's share of the other spouse's earnings. OAR 150-316.048(4).

This proved to be a significant issue for one husband and wife, where the husband and wife worked and lived in Washington, but the husband maintained many connections (driver's license, vehicle registration, mail, etc.) to Oregon. See Sage v. Oregon Department of Revenue, TC-MD 060574C (2007). Husband wound up being subject to Oregon income tax despite his claim that he was a Washington resident. As added injury, because the wife was deemed a resident of Washington, husband owed income tax on his share of his wife's earnings, which were community property under Washington law.

VIII. **RETIREMENT PLANS AND IRAS**

A. ERISA Plans.

Since ERISA is federal law, for retirement and benefit plans that are covered by ERISA (including 401(k)s), ERISA's provisions will preempt state community property if there is any conflict. Thus, to the extent state law diminishes the rights of a participant by granting rights to a non-participant spouse, ERISA's provisions will override state law. Boggs v. Boggs, 520 U.S. 833 (1997). The impact is that where a non-participant spouse in a community property state may otherwise expect to have a *vested* one-half undivided interest in participant spouse's retirement plan, in fact the extent of a non-participant spouse's disposable interest in an ERISA plan appears to be limited to the surviving spouse's annuity, and rights provided for in a qualified domestic relations order. Beyond that, the restrictions on alienation contained within ERISA will override state law to the contrary.

This blanket rule is potentially subject to some exceptions, though that is beyond the scope of this presentation. See, e.g., Emard v. Hughes Aircraft Co., 153 F.3d 949 (9th Cir. 1998), for the existence of certain community property rights in ERISA group life insurance.

B. IRAs.

Most Individual Retirement Accounts are not covered by ERISA. Therefore, state community property law should govern spousal interests in IRAs. See PLR 8040101. However, this can raise a host of potentially problematic issues.

One concern is the consent of the other spouse to the transfer of community property. Some community property states explicitly require consent of both spouses to transfer community property. See, e.g., Cal Fam Code §1100; RCW §26.16.030(2); Koenig v. Bishop, 409 P.2d 102 (Idaho 1965). California also requires spousal consent to any "non-probate transfer" of community property. Cal Prob Code §5000 to 5032. As a result, the beneficiary designation for each spouse's half should be consented to by the other spouse. In addition, a surviving spouse cannot change a predeceased spouse's beneficiary designation as to the decedent spouse's half, unless both spouses have previously signed a consent expressly authorizing future changes.

A related concern is the practical question of how a non-participant spouse distributes his or her interest in the IRA. While each spouse in a community property state would have a one-half interest in the account, the IRA custodian likely permits only the participant spouse to designate a beneficiary. How does the other spouse designate the beneficiary for his or her own one-half interest in the account? The most common suggestion is to include a statement in the non-participant spouse's Will specifying the recipient of the one-half interest in the IRA. This approach is expressly permitted in Washington. RCW §6.15.020(6). However, even with express authorization, if the non-participant spouse is the first to die, the IRA custodian is unlikely to distribute the IRA (a non-probate asset) according to the Will.

In states without express authorization, distributing an IRA interest through a Will is even less certain. In addition, it is not clear how the minimum distribution rules would apply if a portion of an IRA were to be distributed under the Will of a non-participant spouse. The ideal approach may be some combination of a non-probate transfer instrument and a statement of intent in the non-participant spouse's Will backstopping the non-probate instrument. This discussion attempts to raise the issues, but a complete analysis is beyond the scope of this presentation. For the time being, this remains an uncertain issue for planners in community property states.

IX. **CONCLUSION.**

While Oregon may not be a community property state, its geographic location mandates that advisors be aware of the basic nature of community property. The new basis at death for community property can be tremendously advantageous for clients with appreciated assets. Likewise, the loss of community property status for a couple's assets could result in significant taxes that might otherwise have been unnecessary. Attorneys, planners and accountants should be prepared to advise our clients on which actions to take to best protect their community property assets.

APPENDIX A

Revenue Ruling 66-283

Rev. Rul. 66-283, 1966-2 CB 297, IRC Sec(s). 1014

Headnote:

Rev. Rul. 66-283, 1966-2 CB 297 -- IRC Sec. 1014 (Also Sections 2033, 2036, 2038; 20.2033-1, 20.2036-1, 20.2038-1.)

Reference(s): Code Sec. 1014, Reg § 1.1014-2

A husband and wife transferred their California community property to a revocable trust, reserving to themselves a life income interest therein. Upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust is includible under sections 2033, 2036(a)(1) and 2038(a)(1) of the Internal Revenue Code of 1954 in determining the value of the decedent's gross estate. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and its basis is determined in accordance with the provisions of section 1014(a) of the Code.

Full Text:

Advice has been requested with respect to the application of section 1014(b)(6) of the Internal Revenue Code of 1954 to the income tax basis of a surviving spouse's one-half interest in California community property which has been transferred to a revocable trust.

H and *W* are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; *Mears v. Mears* (1960) 4 Cal. Rptr. 618; *Tomaier v. Tomaier* (1944) 146 P. 2d 905. Under California law, community property may also be held by a trustee without losing its character as such. *Berniker v. Berniker* (1947) 182 P. 2d 557. In 1958 *H* and *W* executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under the terms of the trust, *H* and *W,* as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to *H* and *W* as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.

Upon the death of either *H* or *W,* the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of *H,* and the other of the community interest of *W.* During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent's share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor's community interest may be altered, amended, or revoked by the survivor at any time.**<Page 298>**

One of the spouses died in 1965. As of the date of the decedent's death, the trust had not been altered, amended or revoked.

Section 1014(b)(6) of the Code provides, in pertinent part, that in the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, is considered, for purposes of section 1014(a) of the Code, to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (sec. 2001 and following, relating to estate tax).

Section 676(a) of the Code, dealing with power to revoke, treats the grantor as the owner of any portion of a trust where he has at any time the power to revest in himself title to such portion. Section 671 of the Code provides, generally, that where the grantor is treated as the owner of any portion of a trust under subpart E (sec. 671 and following), part I, subchapter J, chapter 1 of the Code, the items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust shall be included in computing the taxable income and credits of the grantor.

For purposes of section 1014(b)(6) of the Code, *H* and *W* are considered as continuing to own the property transferred by them to the revocable trust as their community property.

APPENDIX A

Under section 2033 of the Code the value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death the possession or enjoyment of, or the right to the income from, the property.

Section 2038(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after June 22, 1936, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had **<Page 299>** retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.

APPENDIX B

Internal Revenue Code Section 1014(a)(1) and 1014(b)(6)

(a) *In general*. Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be:

(1) the fair market value of the property at the date of the decedent's death.

…

(b) *Property acquired from the decedent*. For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

…

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939.

…