TAX PLANNING WITH COMMUNITY PROPERTY TRUSTS
APRIL 2022

Community Property Generally

In most community property jurisdictions, all property acquired during marriage, except gifts and inheritances, is considered community property unless the property is "elected out." For instance, if a Husband owns a business prior to the marriage, the Wife could agree that the business remains separate property, and the Husband alone would own the appreciation to the business's value occurring before and during the marriage. There are nine community property states, including:

(1) Arizona
(2) California
(3) Idaho
(4) Louisiana
(5) Nevada
(6) New Mexico
(7) Texas
(8) Washington
(9) Wisconsin

Although no two states have identical community property laws, one thing is consistent within all community property states: their married residents enjoy a significant income tax advantage (with respect to any appreciated assets) in the form of a decreased capital gains tax on community property sold after the death of the first spouse.

In the nine community property states above, spouses are treated as true economic partners for the assets they own while they are married. The law provides that when the first spouse dies, all assets held as community property can receive a "step-up in basis" which means that capital gains tax is calculated based on the difference between the sales price and fair market value at the death of the first spouse. Moreover, upon the second spouse's death, the cost basis is entitled to be stepped-up again such that heirs should be able to sell the property with little or no gain after the second spouse's death. This provides a significant advantage when compared to couples who live in separate property states that only allow one-half of a couple's marital assets to qualify for a step-up in basis on the death of the first spouse.

Community Property Trusts

An effective planning approach involves a couple in a non-community property state creating a community property revocable trust that is located and administered in a jurisdiction that has enacted community property trust legislation. Tennessee and Alaska are the leading jurisdictions that have enacted community property trust statutes. While the statutes are similar, the Tennessee statute has four simple requirements for creating a Tennessee Community Property Trust: (1) a declaration that it is such; (2) at least one "qualified trustee," meaning a Tennessee resident (which can be either or both spouses) or corporate trustee qualified in Tennessee; (3) signatures of both spouses; and (4) specific "warning" language in capital letters at the beginning of the trust instrument.

The terms of a typical community property trust are usually drafted to ensure that the couple continues to enjoy the assets during their joint lifetime and that the surviving spouse also continues to benefit from the trust assets. The property contributed to the trust will also qualify for a full cost basis step-up for income tax purposes upon the death of the first spouse as well as the death of the second spouse.

While there are significant benefits to a community property trust, there are also potential risks, including: (1) the distribution of assets may be modified in the event of a divorce; (2) a Tennessee resident or corporate trustee in the state is required to serve as Trustee while both spouses are alive; (3) property may be subject to creditor claims against either spouse.

Recently Colony Trust Company, LLC opened a Tennessee office in Nashville and is now able to offer corporate trustee services for community property trusts to its clients. Please contact us if you would like more information on community property trusts.

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