(888) 544-6775
expert@peaktrust.com

Alaska Community Property

Gateway to a Powerful Estate Planning Tool

by Brandon J. Cintula, CTFA, Jonathan G. Blattmachr, JD, LLM, and Abigail E. O'Connor, JD

Executive Summary

For 75 years, married couples in community property states have enjoyed a tremendous tax advantage when the first spouse dies: a step-up in basis not just for the deceased spouse's interest in property but also a step-up for the surviving spouse's half interest in the community property.

Initially, only Wisconsin did something about that situation by enacting the Uniform Marital Property Act in 1986. The Internal Revenue Service (IRS) has ruled that this act includes community property for federal tax purposes and therefore allows both halves of a Wisconsin's couple community property to have its basis automatically changed (usually, a step-up in basis) when the first spouse dies.

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In 1998, Alaska adopted community property by a couple electing into its community property system as is permitted in other jurisdictions like Germany. But unlike all other American community property states, the couple does not have to move to Alaska or another community property state. Instead, any married American couple can elect to be in an Alaska community property by creating and funding an Alaska Community Property Trust and thereby enjoy a double step-up in basis when the first spouse dies.

Comment: For decades, the major job for most estate planners was helping their clients avoid estate tax. However, today, with the estate tax exemption (based upon the availability of the unified credit under Section[1] 2010) of about $13 million per decedent, the primary focus is on income tax reduction. There seem to be dozens of ways that income tax in the context of estate planning can be reduced.

This article discusses how married couples not residing in a community property state can hold community property at death and potentially secure the double step-up by transferring the assets to an Alaska Community Property Trust.

1 Throughout this article, any reference to "Section" is to a section of the Internal Revenue Code of 1986, as amended.

Background on Community Property

In most jurisdictions, the law provides special rules for property owned or acquired by married persons. These include entitlement to the property by a surviving spouse, financial support during the marriage, or in the event of divorce.

Generally, those jurisdictions settled by the French or Spanish have a form of community property ownership by the spouses. The closest common law type of ownership of community property is a tenancy-in-common between spouses. But the rights of the spouses and their creditors are quite different between tenancy-in-common property and community property. Although the exact rules and consequences of community property vary from place to place, due to historic differences when the regime was adopted by the jurisdiction and in part on account of subsequent legislation, each spouse typically becomes the immediate owner of (or presently vested in) one-half of assets acquired during the marriage by either spouse under community property regimes, subject to exceptions, such as for inheritances received by one spouse from others. That means, among other things, that each spouse will own half of the couple's community property in the event of divorce or death.

Community Property in the United States

Originally, Louisiana, Texas, New Mexico, Arizona, California, Nevada, Washington (state), and Idaho were the only community property states in America. Puerto Rico and Guam also have community property systems. The exact legal attributes of community property vary and have continued to vary to some degree among these eight states.

Wisconsin adopted the Uniform Marital Property Act in 1986 (UMPA), which has many attributes of traditional community property, and the Internal Revenue Service in Rev. Rul 87-13, 87-2 CB 20, held that Wisconsin's marital property is community property for federal tax purposes.

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In all nine states, the community property regime applies during the marriage, except if the couple "opts out" of the system. If a couple moves from a non-community property state (such as New York or Florida) to one that is a community property state (such as New Mexico or Texas), all the property thereafter acquired while they reside in the community property state will be community property, but their non-community property will not become community property except to the extent the couple opts into it for their previously owned assets, except if it is what is known as "quasi-community property," which is treated in some jurisdictions similarly to actual community property—see, e.g., Cal. Family Code 125 and Cal. Probate Code 100-105.

Other Countries' Marital Property Regimes

Other countries have their own rules for a married couple's property. In Germany, for example, there are three forms of marital property. When a couple in Germany marries, unless they contract otherwise, their wealth essentially falls under a regime somewhat equivalent to the marital property regime in most American states. But the German couple may elect (or opt into) one of the two other different property regimes. One is a separate property regime, similar to what some American couples agree to in a pre-nuptial agreement (in which each spouse says "what's mine is mine and won't be yours"). The German couple can also opt into a regime, and this seems to be the equivalent of traditional community property of the type in Louisiana and the other eight states listed above.

Tax Effects of Community Property

Although the federal government may direct the tax effect of property, the states may direct the legal attributes of the property subject to their respective jurisdictions. The tax consequences often are based on the state law attributes of a couple's property. This dependency has led to a significant disparity in the federal tax treatment of a married couple's property, depending on the state of jurisdiction.

In *United States v. Robbins*, 269 U.S. 315 (1926), the Supreme Court held that income earned on the husband could not be "split" with his wife even though they resided in California, an historic community property jurisdiction. The decision is a bit difficult to understand. It does not say the income was not community property but rather it was proper for the Treasury to tax it all to the husband on account of his authority over the property and that his wife's interest was merely an expectancy.

In contrast, the Supreme Court ruled in *Poe v. Seaborn*, 282 US 101 (1930) that, for a married couple living in the community property state of Washington, only one-half of the income earned by one spouse would be gross income of that spouse and the other half would be gross income of the other spouse because each spouse had a "present vested interest" in the income. This result in *Poe*, was generally beneficial because each spouse would get the "run up" in the income tax brackets, among other income tax benefits.

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Another benefit was that a gift of a community property asset would be treated as one-half made by each spouse, allowing each gift to have a double "run up" in gift tax brackets, allowing two annual gift tax exclusions and allowing two gift tax exemptions with respect to the asset given away. Moreover, this meant that only half of a community property asset would be included in the gross estate of the first spouse to die even if the property had been acquired by the deceased spouse and was titled at death in that spouse's name.

What About Opt-In Community Property?

In the Revenue Act of 1948, the Federal government adopted many new tax rules for married couples who resided outside of community property states that tended to level the playing field for spouses who lived in non-community property states compared to those who lived in community property ones. These changes included allowing spouses to file a joint income tax return (basically, a splitting of their income), to "split" gifts (see Section 2515), allowing 50% of non-community property to qualify as a deduction under Sections 2056 and 2523 (known, of course, as the marital deduction and now unlimited) when given or bequeathed to the other spouse (but now only if the spouse is a U.S. citizen).

However, before the enactment of the Revenue Act of 1948, some states adopted or were considering the adoption of a form of community property. Oklahoma was one state that in 1939 enacted an opt-in form of community property. That is, a married couple in Oklahoma could opt into community property as provided under Oklahoma law. In Commissioner v. Harmon, 323 US 44 (1944), the question was each spouse of a couple who resided in Oklahoma could report one-half of the income that they elected to treated as community property under Oklahoma's recently adopted community property elect-in system.

The Supreme Court ruled that the spouses could not each report one-half of such income. The court says that the system adopted by the Oklahoma couple essentially was one of a contract and basically says it is governed by *Lucas v Earl,* 281 US 111 (1930), which holds that income cannot be anticipatorily assigned for federal income tax purposes. The court also indicates that the holding in *Poe v. Seaborn* is based upon a different marital property system, one built into the law.

The court spends much time pointing out that the community property system in states such as Washington long predate the Sixteenth Amendment to the U.S. Constitution, which authorized the federal income tax. There is also a hint in the decision that the anticipatory assignment of income doctrine applies because the underlying property that generated the income was not community property under Oklahoma law, only the income was.

However, case law, including Westerdahl v. Commissioner, 82 T.C. 83 (1984), and Angerhofer v. Commissioner, 87 TC 814 (1986), discussed below, strongly indicates that if a couple opts into community property under local law that provides for the property to have the attributes of traditional community property, then their property will be respected as community property for federal tax purposes.

IRS View of Harmon

The Internal Revenue Service appears to interpret Harmon as holding either (1) that income from assets that have been converted to community property by consent under a traditional or opt-out community property regime falls under the anticipatory assignment of income doctrine of Lucas v. Earl, just as such income did under Oklahoma's opt-in system, or (2) that Harmon applies only to income that becomes community property by agreement, whether an opt-out or opt-in community property system, where the property that generates the income remains the separate property of one of the spouses. The second interpretation seems more likely the IRS position. Rev. Rul. 77-359, 1977-2 CB 24, dealing with an agreement converting a couple's separate property to community property under Washington state law, states that "[t]o the extent the agreement affects the income from separate property and not separate property itself, the Service will not permit the spouses to split the income for Federal income tax purposes where they file separate income tax returns." The distinction that IRS makes suggests that it views Harmon as applying only to income generated by separate property. The revenue ruling also acknowledges that property converted from separate to community property is community property.

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But There Is Even More!

One might also contend that Federal tax treatment as community property will only be accorded where it is under an opt-out system, as the eight traditional American community property systems and Wisconsin have. But keep in mind that the Supreme Court essentially conceded that, although it would not accord community property treatment for California community property because the "other" spouse did not have an immediate vested interest in the income, it did acknowledge in Harmon that it would accord community property treatment for California community property after the state made statutory changes.

> *"The key takeaway in Angerhofer is that the court did not look to how long a marital property regime had existed in the jurisdiction where the couples resided. Rather, the court looked as to the type of interests each spouse had under the marital property regime that they lived under whether it was a default system or one that couple opted into."*

But an even further development helps clarify what will be considered community property for Federal tax purposes. In *Angerhofer*, the United States Tax Court refused to accept a contention that one-half of the income earned by one spouse, who worked in the United States but was a German national, was properly attributed to the other spouse who remained in Germany for Federal income tax purposes. The court found that the German couple had not opted into the German equivalent of a full regime of community property but strongly suggests that only one-half of the income earned in the United States would have been taxed by the US if they had opted into the full regime of community property under German law. Indeed, in footnote 4, the Tax Court in *Angerhofer* notes that the Internal Revenue Service conceded in its brief to the court that it would respect the income as community property if the couple had opted into the third marital property regime which, as mentioned above, seems to be the equivalent of traditional community property.

The key takeaway in *Angerhofer* is that the court did not look to how long a marital property regime had existed in the jurisdiction where the couples resided. Rather, the court looked as to the type of interests each spouse had under the marital property regime that they lived under whether it was a default system or one that couple opted into.

Necessary Community Property Attributes for Section 1014(b)(6)

Section 1014(b)(6), which gives a stepped-up basis for the surviving spouse's half of community property, requires that: (i) the asset must be "community property… under the community property laws of any State, or possession of the United States or any foreign country;" and (ii) 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 for Federal estate tax purposes. Simply labeling an asset as "community property" or saying a state has a community property system for spouses, where there is no such developed law, may not work for Section 1014(b)(6) purposes. Likely, one must look at the substantive attributes of the applicable community property law and determine whether at least one-half of the value of the whole community property is includable in the deceased spouse's gross estate. Hence, if the jurisdiction does not have a "real" community property system, then it does not seem that the assets can be "community property under the community property laws" of that jurisdiction and, therefore, can fall under Section 1014(b)(6).

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The United States Tax Court has, in at least two decisions, indicated what attributes property must have in order to be treated as community property for Federal tax purposes and that the issue turns on "[w]hether [the laws governing the spouse's property rights] give [the] wife a mature present vested interest in…[the husband's] earned income. If we find in the affirmative and recognize Sweden as a community property jurisdiction for Federal income tax purposes, [the taxpayer] is entitled to treat one-half of his U.S. wages as owned by his wife…." Westerdahl v. Commissioner, 82 T.C. 83, 87 (1984). The Tax Court concluded that the Supreme Court of the United States had decided that to be community property for Federal income tax purposes, there must be the following two broad attributes: "Protection of the interest of each spouse in the community property (1) by legally assuring its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse, and (2) by limiting the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized." Westerdahl, at 91. See, also, Angerhofer, at 825-826.

The "Opt In" Alaska Community Property Regime

Alaska law enacted an "opt in" community property regime that allows both residents and non-residents (married) to elect to make certain property their community property. Alaska Stat. 34.77.010 et seq. The Alaska community property system is based largely on the UMPA, which Wisconsin adopted and the IRS has ruled creates community property, except Alaska adopted an opt-in system rather than an opt-out system which Wisconsin chose. The Alaska system contains virtually all of the same attributes for community property as UMPA does for marital property, with the exception that the Alaska system is opt-in and there is no presumption that all property acquired during the marriage is community property.

Alaska residents may classify any or all of their community property by a community property agreement or by using a community property trust. Nonresidents may classify property as community property by transferring the property to an Alaska community property trust and designating the property as community property in the trust.

The Alaska community property laws include a full suite of rights that attach to community property and govern the spouses' respective rights with respect to such property.

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And it seems virtually certain that Alaska opt-in community property will be entitled to the treated set forth in Section 1014(b)(6). There is an interesting follow up to Oklahoma's community property. Before the enactment of the Revenue Act of 1948, Oklahoma adopted its opt-out form of community property for its married couples. A Mr. and Mrs. McCollum had adopted the Oklahoma opt-in community property regime. In 1945, Oklahoma repealed that law and adopted a mandatory (opt-out) system. But it provided that any property an Oklahoma couple had elected to be treated as community property under the prior opt-in system would be community property under the new opt-out system. The United States District Court held that such opt-in community property would fall under the double step-up in basis rule under the predecessor to Section 1014(b)(6) which was adopted in the Revenue Act of 1948. McCollum v. United States, 58-2 USTC Para. 9957 (N.D.Ok. 1958). Essentially, the step-up basis treatment was applicable to the opt-in community property.[2]

Summary and Conclusions

The Alaska community property system offers both residents and nonresidents the potential income tax advantages of community property. Because it is an "opt in" system, spouses can be choosy and elect to create community property status only when there are potential income tax advantages for doing so. The ability for nonresidents to use Alaska community property trusts makes the regime even more desirable because it offers potential benefits to those throughout the United States.

An Alaska community property trust has certain requirements, all of which are reasonably straightforward. For nonresidents, the important considerations are as follows. One, there needs to be at least one Alaskan trustee.

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However, that trustee's duties can be limited to certain administrative matters. The settlors can designate themselves as Investment and Distribution Trustees and still retain control over all of the significant aspects of the trust administration. Two, at least some of the assets need to be held in Alaska, often in the form of a financial account held by the Alaskan trustee at an Alaskan financial institution. Three, at least some of the trust administration needs to occur in the state of Alaska. Nonresidents who create Alaska Community Property trusts seem to find these requirements very doable and worth the potential benefits that the state legislation has to offer.

2 See discussion in Trice, "Community Property in Oklahoma", 4 SWLJ 38 (Jan. 1950), available at https://scholar.smu.edu/smulr/vol4/iss1/3.

Citations

Alaska Trust Act; Uniform Marital Property Act; Cal. Family Code 125 and Cal. Probate Code 100-105); Blattmachr, Zaritsky and Ascher, “Tax Planning with Consensual Community Property: Alaska’s New Community Property Law,” 33 RPPTL Jl 615 (1999); Sections 1014, 2010, 2056, 2515; Rev. Rul 87-13, 87-2 CB 20; Rev. Rul. 77-359, 1977-2 CB 24; United States v. Robbins, 269 U.S. 315 (1926); Poe v. Seaborn, 282 US 101 (1930); Revenue Act of 1948; Commissioner v. Harmon, 323 US 44 (1944); Lucas v. Earl, 281 US 111 (1930); Westerdahl v. Commissioner, 82 T.C. 83 (1984); Angerhofer v. Commissioner, 87 TC 814 (1986); McCollum v. United States, 58-2 USTC Para. 9957 (N.D.Ok. 1958); Trice, “Community Property in Oklahoma”, 4 SWLJ 38 (Jan. 1950)

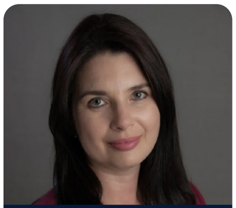
About the Authors

BRANDON CINTULA, CTFA

Brandon Cintula, CTFA, CFIRS, is a highly respected trust professional with over 25 years of experience in sophisticated trust planning and administration, currently serving as the Senior Vice President & Chief Operating Officer at Peak Trust Company. His expertise lies in working with complex estate planning techniques, encompassing a wide range of trust types and asset classes. He holds a Bachelor of Science degree in Finance from Northern Arizona University and has earned the prestigious Certified Trust and Financial Advisor (CTFA) and Certified Fiduciary Investment Risk Management Specialist (CFIRS) designations from the Cannon Financial Institute with honors.

JONATHAN G. BLATTMACHR, JD, LLM

Listed in The Best Lawyers in America, Jonathan G. Blattmachr is a Principal in Pioneer Wealth Partners, in the estate planning advisory group. He gives lectures and has written extensively on estate and trust taxation and charitable giving. Mr. Blattmachr was a Harlan Fiske Scholar at the Columbia University School of Law, where he received his law degree and graduated cum laude. He has an A.B. from Bucknell University in mathematics. Mr. Blattmachr has written nine books and over 500 articles on estate planning and other tax issues. He has been an Advisor on The American Law Institute, Restatement of the Law, and Trusts 3rd; he is a member of the American Bar Foundation. He is a retired member of Milbank Tweed Hadley & McCloy LLP and of the Alaska, California and New York State bar associations.



ABIGAIL E. O’CONNOR, JD

Abigail O’Connor is an accomplished attorney with over 15 years of experience dedicated to trusts and estates. Her specific practice areas include estate planning, estate and gift tax strategic planning, Alaska trusts for both Alaskans and non-Alaskans, representation of trustees and beneficiaries, estate administration, and family business succession planning. Abigail is the Alaska State Chair of the American College of Trust and Estate Counsel and holds a Martindale Hubbell “AV” rating. Abigail is licensed in Alaska and Florida, holds a JD with a concentration in Estate Planning from Albany Law School, an MS in Applied Mathematics from Rensselaer Polytechnic Institute, and a BA in Mathematics from Rutgers University. Abigail is an active member of various professional organizations and has authored numerous publications and presented at many conferences and seminars on topics related to estate planning, trusts, and tax law.

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