Estate Planning

Community property trust may reduce potential taxes for married couples.

By Chad Whitfield, JD

There are two very different kinds of property ownership law for married couples in the United States: community property law and common law (also known as separate property states). Varying nuances exist in the specifics of these property ownership forms across the states, but certain general rules are applicable. Essentially, any state that is not a community property state is a common-law state.

Community property states offer a distinct tax advantage for a married couples' assets when one spouse dies. However, several common-law states have passed laws that allow married couples residing in any common-law state to establish a community property trust (CPT). This benefit, previously unavailable in common-law states, allows for a "step-up" or adjustment in the cost basis of inherited assets. Stepped-up basis is when the price of an inherited asset on the date of the decedent's death is raised to its current fair market value (FMV), which can minimize capital gains taxes if the asset is subsequently sold.

Community Property States

Community property is an ancient property ownership system developed from Spanish civil law that bestows each spouse with a one-half interest in the couple's community property. Under this structure, essentially all property of a married couple is held as community property except property acquired in a manner excluded from such treatment, for example, gifts, inheritances, or assets subject to a separate property agreement. In the United States, nine states operate under community property law: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. While the exact application of the community property system varies from state to state, community property may be subject to creditor claims of either spouse and may be divided other than equally in the event of a divorce. At death, each community property asset is divided equally between the surviving spouse and the decedent spouse's estate.

Under federal income tax law, community property can have considerable income tax planning benefits at the death of the first spouse. The essential advantage of community property ownership is that when the first spouse dies, both spouses' interests in the community property, not just the decedent's interest, receive a step-up in basis for income tax purposes (up to FMV).[1]

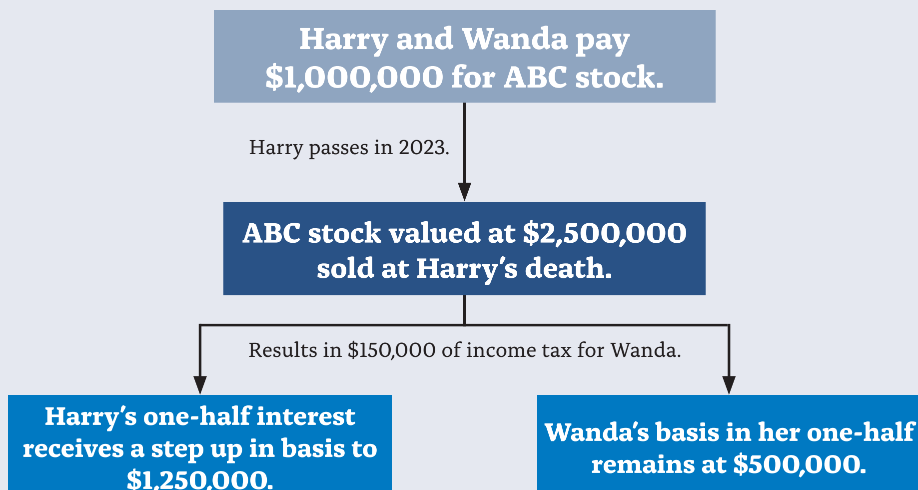
Common-Law States

Under common law, married couples typically own assets jointly or individually. Upon the death of the first spouse, the value of assets in the decedent's name, or in the name of a revocable trust, are adjusted to current FMV. Assets held jointly at death receive this full step-up in basis to the full value of the property owned by the decedent only. Unfortunately, the basis of the assets held in the surviving spouse's sole name are not stepped up. However, when the surviving spouse passes, assets held in her or his sole name may get a step-up in basis.

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

EXAMPLE 1:

Harry and Wanda paid $1,000,000 for ABC stock, titled equally as tenants in common. If Harry dies in 2023 and all the stock is now worth $2,500,000, Harry's one-half interest receives a step-up in basis to $1,250,000, but Wanda's basis in her half remains at $500,000. If Wanda sells the ABC stock for $2,500,000, total basis is $1,750,000, equating to a total gain of $750,000, which at a 20% capital gain rate, results in $150,000 of income tax.



Community Property Trusts (CPTs)

CPTs are joint trusts that are created by married couples. They essentially allow spouses in common-law jurisdictions to enjoy the same benefits as spouses in community property states. Using this type of trust provides the couple with the tax advantage of a double step-up in basis. States such as Alaska and Tennessee allow non-resident couples to form a CPT, assuming statutory requirements are satisfied.

Common-law states providing CPTs

To date, five common-law states have passed CPT statutes that allow a married couple to opt-in to the community property trust system and convert common-law property into community property: Alaska, Florida, Kentucky, South Dakota, and Tennessee. The intent of CPTs is to allow married couples living in the resident state, and others living in common-law states, to also obtain a stepped-up basis to all assets they own at the first death, just like in community property states. Married couples that live in a common-law state that fail to offer this trust solution may establish a CPT in states like Alaska and Tennessee, but they must appoint a qualified trustee in that state.

Mechanics of CPTs

To better understand the mechanics of a CPT, example 2 describes the Tennessee CPT. Understanding how this particular trust works should generally prepare residents of other common-law states to consider the strategy afforded by the CPT states.

The Tennessee Community Property Trust Act (TCPTA) of 2010[2] empowers married couples to convert their individual assets into community property. Each spouse is considered to own an undivided one-half interest in every asset conveyed into a CPT.

Accordingly, IRC §1014(b)(6) applies in the same way as with community property states to allow a step-up in basis to the date of death value for the entire CPT upon the death of the first spouse.

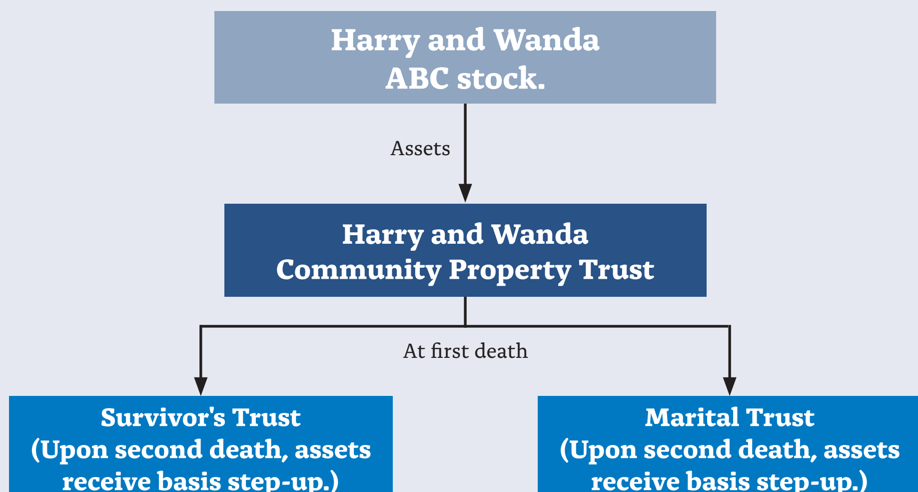
2 T.C.A. Section 35-17-101, et. seq.

EXAMPLE 2:

In example 1, above, the transfer of Harry and Wanda's ABC Stock resulted in a $150,000 tax liability.

However, if instead Harry and Wanda contributed their ABC Stock into a Tennessee CPT, then when either spouse dies, all stock gets a step-up in basis to fair market value ($2,500,000).

The survivor can then sell the stock without the capital gain. This allows the family to retain a larger amount of their wealth.



At the first death, the CPT will divide assets into a survivor's share and a decedent's share. Then, these shares can fund an irrevocable survivor's trust and an irrevocable marital trust for the benefit of the surviving spouse. If properly drafted, these trusts will obtain another step-up in basis as the surviving spouse's death. As such, the trusts will not only avoid federal capital gain taxes for trust assets sold by a surviving spouse, but also should further avoid capital gain taxes when the assets are sold by subsequent trust beneficiaries.

Under the TCPTA, a CPT can be voluntarily funded with some or all of the married couple's assets. There is no requirement that the asset be marital property. In addition, a couple may transfer any property owned jointly or solely by either of them into the CPT. Through the provisions of the CPT, the couple may determine: (a) rights and obligations in the trust assets regardless of when and where the property is acquired or located; (b) disposition of the assets upon death, dissolution or other event; and (c) any other matter impacting trust property that is consistent with public policy.

Each CPT state has its own set of rules and nuances in properly establishing a CPT, but there are four general requirements for creating a community property trust:

1. A declaration that the trust is a CPT;
2. At least one "qualified trustee," typically meaning a resident or qualified bank located in the CPT state;
3. Signatures of both spouses; and
4. Specified "warning" language in capital letters at the beginning of the trust document.

Effectiveness of a CPT

While the implementation of a CPT may seem desirable to married couples in common-law states, there are a few items to further consider.

The IRS has not confirmed whether a step-up in basis applicable to community property under IRC §1014(b)(6) will apply to assets held by a CPT. The IRS's comprehensive Publication 555, Community Property, specifically states that "this publication does not address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws." Conversely, for the nine community property states, the publication discusses not only who is subject to tax on income from community property but also the step-up in basis on the death of one spouse. Further, some commentators have noted that a CPT does not protect parties' assets as strongly as tenancy by the entirety ownership when there is a debt owed by one spouse.

Conclusion

For married couples that wish to retain a greater amount of their wealth, the utilization of a CPT should be considered. A CPT may provide a double step-up in the basis of trust assets, thereby allowing the married couple to retain more wealth by minimizing the impact of capital gains tax.

If highly appreciated assets comprise part of your estate, you may want to talk with your financial service professional to see if a CPT should be part of your overall estate plan design.

Chad Whitfield, JD, joined The Nautilus Group in 2020, bringing more than 20 years of experience in tax, planning, and design expertise within the estate, trust, and wealth planning niche to assist Nautilus members and their clients with estate planning techniques, asset protection strategies, and succession planning structures. He received his JD from St. Thomas University School of Law, Miami, in 1996, and his BA in political science and English from East Tennessee State University in 1993. Chad is a member of the Florida Bar, the Tennessee Bar, and the U.S. Tax Court.

This material includes a discussion of one or more tax related topics. This tax related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purposes of avoiding any IRS penalties that may be imposed upon the taxpayer. As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For asset transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life, and employees and agents thereof are not in the business of providing tax, legal or accounting advice. Individuals should consult with their own tax, legal or accounting advisors before implementing any planning strategies. SMRU 5641924 Exp. 4/30/2025