WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Life Insurance Planning and Community Property

MARKET TREND: With an increasingly mobile society, more married couples are likely to live in community property states and acquire community property rights, which can pose unique challenges for gift, estate and life insurance planning.

SYNOPSIS: Community property states have unique marital property regimes, which provide each spouse with an automatic 50% community property interest in all assets that result from the labor, efforts and skills of either spouse, regardless of which spouse acquired the property. A community property interest also can be created in a separate property business or other asset if the owner-spouse devotes time and effort to the management of the business or asset during the marriage. Absent any contrary action taken by the couple, community property usually retains its character, even after relocation to a non-community property state. While community property offers the unique benefits of a step-up in tax basis for the entire property at the death of the first spouse (and not just for the deceased spouse's ½ interest), its use in funding irrevocable life insurance trusts, particularly those benefiting one spouse, can complicate planning and lead to unintended estate tax consequences if not properly managed.

TAKE-AWAYS: Advisors with clients who have ever lived in a community property state must work closely with these clients to identify which assets (or parts thereof) may constitute community property. This is particularly important when one spouse funds an irrevocable life insurance trust or spousal lifetime access trust benefiting the other spouse. Using community property in such cases can result in unintended gifts by the beneficiary-spouse and estate tax inclusion of part of the trust assets in that spouse's estate at death. If community property will be used, it should be converted to separate property prior to transfer. Otherwise, advisors should carefully weigh the overall benefits to their clients before converting community property to jointly-owned separate property, as it eliminates the ability to achieve a double step up in tax basis at the first spouse's death.

PRIOR REPORTS: ***13-29; 13-08; 12-41.***

Given a fairly limited number of community property states, planning with community property can be a foreign concept for many advisors. With our increasingly mobile society, more married

couples are likely to live in community property states at some point and acquire community property rights. Thus, all advisors should have a general understanding of basic community property principles, advantages, and planning issues, particularly as they may impact life insurance planning.

COMMUNITY PROPERTY BASICS

Community Property States. There are nine community property states ("**CP states**"): ***Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin***. In addition, ***Alaska and Tennessee*** allow resident and nonresident married couples to elect to hold property as community property.[1]

Community vs. Separate Property. Generally, in CP states, property owned by a spouse (and, in some states, registered domestic partners[2]) prior to marriage, along with property acquired by that spouse during the marriage by gift or inheritance, is characterized as that spouse's separate property. All other property acquired by either spouse during marriage while domiciled in a CP state, including the income and profits from such property, and the results of the labor, efforts and skill of each spouse, is community property, in which each spouse owns a 50% undivided community property interest (regardless of how the property is titled).

Character Retention. Community property characterization ***survives the sale of the asset and attaches to the proceeds*** and any assets subsequently acquired with such proceeds. In addition, states generally look to the state in which the couple was domiciled when property was acquired to determine the character of such property, which means community property usually retains its character even if a couple relocates to a non-CP state, unless the couple takes separate action.[3]

All Assets. Community property encompasses all assets acquired from a spouse's labor, efforts or skill, including ***life insurance purchased with community property earnings or funded by an employer, IRAs and other retirement plans funded with community property earnings, and stock option plans***.

- ✓ ***Practice Note:*** Given that community property often retains its classification and the legal titling of the property may not reflect its community property status, advisors with clients who have ever lived in a CP state must work closely with these clients to identify which assets (or parts thereof) may constitute community property. Failure to recognize an asset as community property can result in adverse gift and estate tax consequences, as noted below.

CHANGES IN PROPERTY CHARACTERIZATION

Although community property typically retains its classification, the characterization of property as separate or community, as well as the income or appreciation from that property, can change, based on the actions of a married couple (whether or not intentional) or by application of law, including as follows:

Marital & Transmutation Agreements. Spouses can agree to modify their community and separate property rights by entering into a premarital or post-marital agreement. They also can agree to transmute a specific community property asset into separate property, or vice versa. Although a written agreement generally is needed, state law requirements for a valid and enforceable marital or transmutation agreement vary and must be reviewed before entering into such an agreement.

Spousal Management of Separate Property. Even if an asset starts out as a spouse's separate property, if a spouse's labors during the marriage increase the asset's value or generation of income, part of the asset (and its income) may be community property. This situation usually arises where one spouse owns a business prior to the marriage. When applied to managing the business, that spouse's labor, efforts and skills, which are community property, have the effect of mixing separate property (the business assets) with community property (the spouse's labor), causing part of the business' income and/or appreciation to be community property.

Quasi-Community Property. Laws in California, Texas, Arizona, New Mexico and Louisiana alter the character of certain assets acquired by spouses while married but before moving to a CP state. An asset that would have been community property if the couple lived in a CP state at the time of acquisition becomes "quasi-community property," which, as discussed below, is treated differently from community property for federal estate tax purposes.

- ✓ ***Practice Note:*** Advisors must carefully analyze whether the community property character of an asset should be preserved or terminated and ensure proper documentation of the status. For example, properly drafted and executed marital or transmutation agreements should be used to identify or document conversions of community to separate property. Also, clients should consider maintaining an inventory of community and separate property assets and recording the source of funds used to acquire each asset. Clients also may want to establish separate accounts for community and separate property and/or establish a joint revocable trust to hold community property and separate trusts for separate property to avoid commingling.

GIFT AND ESTATE TAX CONSIDERATIONS

Gifts. A gift of community property is a gift from both spouses, with half of the gift reported by, and taxed to, each spouse (in excess of the couple's available gift tax annual exclusions).

Transfers at Death. At death, a spouse may dispose of only his or her half of the community property by will, revocable trust, etc.[4] For estate tax purposes, the deceased spouse's half of all community property (and 100% of his or her separate property) is included in the deceased spouse's estate and receives a "stepped-up" basis for capital gains tax purposes. ***The surviving spouse's half of the community property also receives a basis step-up at this time***.[5] This so-called "**double step-up**," which is unique to community property ownership, can offer a significant tax benefit, particularly for low basis assets.[6]

> *Example:* H and W, husband and wife, jointly own land with a $5 million value and $1 million tax basis ($500,000 each). H dies and his half share (valued at $2.5 million) passes to W, who immediately sells the land for $5 million.

	Community Property	Non-Community Property
Total Basis Step-Up at H's Death	$5 million (H and W's share stepped up)	$3 million (only H's share stepped up)
Land Sale Proceeds	$5 million	$5 million
Potential Taxable Gain (at up to 20%)	**$0**	**$2 million**

Note that, since the U.S. Supreme Court decision in Windsor v. U.S. (2013), ***lawfully married same-sex couples with community property (but not registered domestic partners or those in similar state law arrangements) also should benefit from the double step-up in basis.***

Quasi-community property, however, is still treated for federal estate tax purposes as the separate property of the spouse who originally acquired it, so that a basis step-up only occurs at the death of that spouse. For example, using the facts from above, assume H holds the land acquired during his marriage to W. They move from a non-CP state to California, where the land becomes quasi-community property. If W dies first, no share of the land is included in her estate or receives a step-up in basis. If H dies first, the land receives a full basis step-up because it is treated as H's separate property for federal estate tax purposes; however, H can only bequeath half of the land at death – the other half passes to W.

- ✓ ***Practice Notes:*** When presented with community property, advisors in non-CP states should weigh the benefits to their clients of converting community property to joint but separate property (*e.g.*, by joint tenancy or other joint ownership form). Although the conversion separates and preserves each spouse's one-half interest in the assets, it eliminates the ability to achieve a double step in basis at the first spouse's death. This change may not be ideal for low basis community property assets.

IMPLICATIONS FOR LIFE INSURANCE PLANNING

Policies as Community Property. Given the above, advisors should be particularly sensitive to potential community property interests when dealing with life insurance. If insurance policies are purchased with community property funds, the policies and the proceeds are also community property, absent an agreement between spouses. Each spouse will have an ownership interest in the policies and ***only one-half of the proceeds will be included in the insured's estate at death***.

> *Example:* H and W live and work in a CP state. H is covered by a $1,000,000 group term life insurance policy paid for by his employer. Since the rights in the group term policy were acquired through H's labors, they are community property. At H's death, only half ($500,000) of the proceeds are included in his estate, with the other half belonging to W. ***If however, H names someone other than W as the policy beneficiary, W will be deemed to have made a gift to the beneficiary in the amount of $500,000 upon H's death***.

ILIT/SLAT Funding. When creating and funding irrevocable life insurance trusts ("**ILITs**") designed to benefit the non-insured spouse (common with so-called spousal lifetime access trusts or "**SLATs**"), care should be taken to use only the separate property of the non-beneficiary spouse, not community property. Otherwise, adverse estate tax consequences may result.

For instance, assume a husband acquires a life insurance policy using community property proceeds (*e.g.*, his salary or employer benefits provided during the marriage). The policy is considered community property, owned one-half by each spouse. A gift of that policy by the husband to an ILIT/SLAT benefiting his wife will be considered a gift made by the wife with a retained beneficial interest, resulting in inclusion of part of the trust assets in her estate at death.

The same principle applies to other spousal contributions or annual gifts made to such an ILIT/SLAT (such as for the payment of any insurance policy premiums). Gifts to the ILIT/SLAT of community property funds will be deemed made in part by the beneficiary spouse, again resulting in inclusion of part of the ILIT assets in the beneficiary spouse's estate at death.

✓ ***Practice Notes:***

- Prior to transfer, the advisor and clients should review and confirm that the policy and/or other property intended for funding into the ILIT/SLAT is the transferring spouse's separate property (*e.g.*, the policy has not been acquired through the use of community property funds (including earnings from the spouse's labor or skill) or the assets/money comes from the transferring spouse's separate account).

- If the clients want to transfer assets characterized as community property, the beneficiary spouse should relinquish any community property rights in the policy/property. Depending on state law, this may require execution of a marital or transmutation agreement. Ideally, for each transfer, these issues should be analyzed and any required agreements or other documents executed in advance of the ILIT/SLAT's funding.

TAKE-AWAYS

- Advisors with clients who have ever lived in a CP state must work closely with these clients to identify which assets (or parts thereof) may constitute community property.

- Identification is particularly important when one spouse funds an ILIT or SLAT benefiting the other spouse. Using community property in such cases can result in unintended gifts by the beneficiary-spouse and estate tax inclusion of part of the trust assets in that spouse's estate at death. If community property will be used, it should be converted to separate property prior to transfer.

- Otherwise, advisors should carefully weigh the overall benefits to their clients before converting community property to jointly-owned separate property, as it eliminates the ability to achieve a double step up in tax basis at the first spouse's death.

NOTES

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[1] In Alaska and Tennessee, nonresidents must use a community property trust to hold community property. In Tennessee, residents electing the community property regime must also use a community property trust. However, in Alaska residents may opt into the community property regime without the requirement of a community property trust.

[2] California, Nevada and Washington allow unmarried couples (including same sex couples) to register as domestic partners. Registered domestic partners in these states are subject to the same community property regime as married couples. Generally, the community property ownership rules discussed in this report also apply to registered domestic partners. However, the surviving domestic partner's share of the community property will not receive a stepped up basis on the death of the first partner for federal income tax purposes (but may for state income tax purposes). *See*, Rev. Proc. 2013-17, 2013-38 IRB 201.

[3] Sixteen non-CP states (Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia and Wyoming) have adopted the Uniform Disposition of Community Property Rights at Death Act (1971), which specifically preserves each spouse's interest in community property acquired while domiciled in a CP state, unless the spouses have otherwise indicated an intention to sever or alter their community property rights. This allows each spouse to dispose of his or her half of the community property at death and enables the entire community property to receive a stepped up basis on the death of the first spouse (as discussed under "Gift & Estate Tax Planning Issue" herein).

[4] Otherwise, a deceased spouse's community property share generally will pass to the surviving spouse under applicable state intestacy laws. Note that state intestacy law may require a different distribution of the deceased spouse's separate property, for example, by providing the surviving spouse with only a portion of the separate property and awarding the rest to the deceased spouse's surviving children, if any.

[5] IRC § 1014(b)(6).

[6] The double step-up in basis also resets the community property's value for purposes of calculating depreciation.

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