

Community Property Trusts

Ah, Alaska! Like its melting glaciers, its trust law, heated by an unabashed desire to promote Alaskan trust business, has largely dissolved into a lake of reform. Tennessee has fished this lake and brought home catch. Limited by the rule against perpetuities? Abolish it![1] Bothered by creditors reaching self-settled trusts? Shelter them![2] In these triumphs of trust economics, one might wonder whether state legislators have adequately weighed the long-term social costs and benefits of such radical innovations.[3]

"Effective July 1, 2010, Tennessee residents and nonresidents alike can elect to treat some or all of their assets as community property."

One Alaskan idea copied by Tennessee, however, is just unquestionably good news — Tennessee's Community Property Trust Act of 2010,[4] the second such act in the nation after Alaska's. Effective July 1, 2010, Tennessee residents and nonresidents alike can elect to treat some or all of their assets as community property.[5]

Income Tax Benefit

The primary advantage of electing community property status is that when the first spouse dies (other than in 2010),[6] 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 fair market value) under Code section 1014(b)(6).

Example 1: H and W paid $1,000,000 for XYZ stock, titled as equal tenants in common. If H dies in 2011 and all the stock is worth $2,500,000, H's one-half interest gets a step-up in basis to $1,250,000, but W's basis in her half is still only $500,000. If W sells all the XYZ stock for $2,500,000, total basis is $1,750,000, so total gain is $750,000, which at a 20 percent capital gain rate causes $150,000 of income tax.

If, instead, H and W contribute their XYZ stock to a Community Property Trust, then when either spouse dies, all the stock gets a step-up in basis to fair market value, i.e., $2,500,000. The survivor can then sell all the stock without capital gain.

Gift and Estate Tax Benefits

There are two primary gift and estate tax advantages of electing community property status.

First, community property trusts make it easier for clients to "equalize" ownership of their assets, so that both spouses can be more likely to fully utilize their separate death tax exemptions. Since each spouse is treated as owning an undivided one-half of all community property, the effect of the death of one spouse is for the decedent's one-half interest to pass by will (presumably to create a credit shelter trust) and for the survivor's one-half interest to become his or her property outright.

Example 2: In 2011, both the federal estate tax exemption and Tennessee inheritance exemption are $1,000,000 per decedent. H and W have a combined net worth of $2,500,000. Each of them needs at least $1,000,000 in his or her separate name so that regardless of the order of death, the first to die will be able to fully utilize his or her exemption to fund a credit shelter trust. The usual solution is for the spouses to divide

their assets, each having separate property of at least $1,000,000.

If, instead, H and W create a Tennessee Community Property Trust, then they need not keep track of how much is in each name. When one of them dies, one-half of all community property will automatically be part of the decedent's estate.

Second, because each spouse owns an undivided one-half interest in all community property, each half may be eligible for a discount in value for transfer tax purposes on account of being a fractional interest,[7] especially if the community property is real property or a closely held business interest.

Example 3: H owns a business worth $1,000,000, W owns a lake house worth $1,000,000, and H and W own another $500,000 jointly, for a total net worth of $2,500,000. If both died in 2011, even if they both fully utilized their $1,000,000 federal and Tennessee death tax exemptions, the amount subject to tax at the second death is $500,000, and the combined Federal and Tennessee death tax is $210,000.

If, instead, H and W contribute all their assets to a Tennessee Community Property Trust, then when each spouse dies, his or her estate will consist of one-half of each asset in the Trust. If the one-half interest in the business is discounted by 25 percent, the discount on $500,000 would be $125,000. If the one-half interest in the lake property is discounted by 15 percent, the discount on $500,000 is $75,000. Accordingly, total discounts at each death are $200,000, or $400,000 combined for both estates. Effectively, they have reduced their net worth for death purposes from $2,500,000 to only $2,100,000. When the second spouse dies, the taxable estate is only $100,000, and the combined federal and Tennessee death tax is $41,000, a savings of $169,000.

Simplicity

The beauty of Tennessee's "opt-in" community property system is its simplicity. Whatever is in a married couple's Community Property Trust is community property, and whatever is not in the Trust is separate property.

By contrast, the laws of the various community property states are often complex and inconsistent. Examples are how to determine which assets are separate property, the treatment of income from separate property, the effect of commingling of separate and community property, or what happens when community funds are used to improve one spouse's separate property.

In designing a Tennessee Community Property Trust, spouses have wide latitude, and may agree between themselves on various rights and obligations, control, disposition upon death, divorce, or other contingencies, and whether the trust, or any specific provision of the trust, is revocable or irrevocable. Virtually the only statutory default that the spouses cannot alter is that at the death of the first spouse, each spouse owns one-half of each asset in the Trust and each retains control over his or her half.

Caveats

Since statutory defaults govern in the absence of the spouses' agreement in the trust instrument, each spouse should be diligent to review the language carefully. For example, in the event of a divorce, the default is not only that the trust is divided between the spouses, but each trust asset is split between them. This suggests that Community Property Trusts may, in many contexts, have the nature of post-marital agreements, with all the requirements and protections against overreaching those entail.[8] Unlike other post-marital agreements, however, the statute does clarify that for this purpose there is no requirement of consideration.

Creditors of a spouse can reach that spouse's interest in a Tennessee Community Property Trust, and creditors of both spouses can reach both spouses' interests. In other words, there is little or no

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Bank on It

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cause regulators to impose higher capital standards on all depository institutions. Capital, for a bank, is the cushion against losses, and that cushion just took on "Princess and the Pea" proportions.

In its 16 separate titles, Dodd-Frank deals with many other issues, too broad for this column, but for interested readers and insomniacs, there are many good summaries on various law firms' websites, including www.millermartin.com. Shameless promotion, but I think we did a pretty good job.

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creditor protection, and spouses should be aware that other forms of ownership, such as tenancy by the entirety, may be more beneficial for that purpose.

Requirements

There are 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 bank qualified in Tennessee; (3) signatures of both spouses; and (4) specific "warning" language in capital letters at the beginning of the trust instrument.

The Community Property Trust Act is an elegant addition to the tools of Tennessee estate planners. With it and many other modernizations, Tennessee continues to compare favorably in its trust and estate law with the best states in the nation.

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Notes

1. See Holbrook, "The Rule Against Perpetuities: Time to Re-Examine?" *Tennessee Bar Journal* (April 2002).

2. See Holbrook, "The TIST Test: Tennessee Competes for Trust Dollars," *Tennessee Bar Journal* (August 2007), and Holbrook, "When to TIST? Here's a List," *Tennessee Bar Journal* (November 2007).

3. See, for example, Ray D. Madoff, *Immortality and the Law: The Rising Power of the American Dead*, Yale University Press (2010).

4. Tenn. Code Ann. §35-17-101, et seq.

5. Generally, nine states follow a community property system (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Wisconsin and Washington, along with Puerto Rico), under which spouses are presumed to own all property equally, regardless of titling, unless specifically excepted as separate property. The other 41 states are separate property states, under which title to property determines the rights of ownership, including the right of control and right of disposition during life or at death. Of those 41 states, only Alaska and Tennessee offer the option to "elect," or to "opt in" to, community property status.

6. For a death in 2010 (based on the law as of the time of this writing), the federal estate tax is not applicable and there is no automatic step-up in basis to fair market value. Instead, under Code section 1022, there is a $1.3 million basis step-up that the executor can allocate at his discretion, plus another $3 million step-up in basis for assets passing to a spouse, for a total of $4.3 million increase in basis.

7. See Holbrook, "Fractional Interest Discounts: Not If, But How Much," *Tennessee Bar Journal* (August 2010).

8 See, e.g., 15 Tennessee Practice 2d Legal Forms: Family Law and Estate Planning § 1:29, Postnuptial Agreements (Nancy Fraas MacLean ed., 2002 & Supp. 2009).

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