

# Practice Alert: Alaska Community Property Act: A Potential New Opportunity in Estate Planning for Some Married Americans

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The Alaska Community Property Act, signed into law in May, allows a married Alaskan or an Alaskan married couple to elect for some or all of his, her or their property to become community property, and permits married persons not resident in Alaska to create community property under Alaska law through an Alaska Community Property Trust. This law is derived from the Uniform Marital Property Act ("UMPA"), which had previously been adopted only by Wisconsin. Although the UMPA calls the property it covers "marital property", it is in essence community property for tax purposes. Rev. Rul. 87-13, 1987-1 C.B. 20 (Wisconsin law). It is called "community property" under the Alaska Act.

Community property is the basic marital ownership regime in Louisiana, Texas, New Mexico, Arizona, Nevada, California, Washington (state), Idaho and Wisconsin. The definition of when property is community property varies considerably from state to state. Indeed, it might be contended that the distinction between community property and certain other property held by a married person or persons has largely been eroded over time, particularly when non-community forms of ownership are coupled with concepts such as entitlement to a minimum or elective share upon the death of the first spouse to die and equitable distribution at divorce.

## Tax Advantages of Community Property

Community property long received more advantageous tax treatment than other forms of property owned by married persons. Prior to the allowance of joint income tax returns in 1948, each spouse could report and be taxed on one-half of community property income, reducing the effect of the progressive income tax rates. See *Poe v. Seaborn*, 282 U.S. 101 (1930). Similarly, prior to gift-splitting and the estate tax marital deduction, only one-half of assets held as community property would be included in the estate of the first spouse to die. Only one-half of a gift of a community property asset to one's spouse would be subject to gift tax, and a gift of community property to someone other than one of the spouses was treated as made one-half by each spouse. Those differences were so beneficial that several states converted or considered converting their basic ownership regime for married couples resident in their states to community property.<sup>1</sup>

The tax differences between community property and non-community property of married persons were largely extinguished in and after 1948 by the allowance of joint income tax returns for married couples, the estate tax marital deductions for one-half of the adjusted gross estate of the spouse first to die, the gift tax marital deduction for one-half of the assets given to one's spouse, and the gift-splitting election to treat gifts by one spouse to someone other than his or her spouse as made one-half by each spouse. When these were enacted, the marital deduction was not available for transfers of community property to one's spouse. See, e.g., Code Sec. 2056(c)(2)(B), (C) and Code Sec. 2523(f) as in effect prior to 1982.

These 1948 tax law changes largely tended to produce parity between community and noncommunity property states. However, Code Sec. 1014(b)(6) provides that the income tax basis of both halves of an item of community property will be increased (or decreased) to their value on the date of the death of one of the co-owners or, if elected, the alternate valuation date. In other words, both halves of the community property receive the income tax-free step-up in income tax basis when the first spouse dies. Thus, when one spouse dies, a married couple who hold all their assets as community property receives a change in basis for all of their community property. By contrast, if non-community property were owned by the same couple as equal tenants in common (probably the closest non-community form of ownership to community property), only the half owned by the first spouse to die would have its basis changed at the first spouse's death. If the asset had been community property, the basis of the entire asset would change when the first spouse died.

## The Alaska Community Property Act

The Alaska Community Property Act permits married Alaskans to elect for all or part of their assets to constitute community property under Alaska law. Also, by transferring assets to an Alaska Community Property Trust, a married person or persons residing in other states may convert all or part of his, her or their assets to community property under Alaska law. Alaska community property is essentially the same as community property in Wisconsin—both being derived from UMPA. Because community property under Alaska law, like community property under Wisconsin law (or that of any other state), is community property under the "community property laws of [a] State," Alaska community property should logically receive the same basis treatment under Code Sec. 1014(b)(6) as does community property under the law of any other state. See Rev. Rul. 87-13, *supra* (Wisconsin marital property is community property under Code Sec. 1014(b)(6)). This logical result should follow legally, though one must pay heed to

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certain anomalies in the historic development of the tax treatment of community property.

In *Commissioner v. Harmon*, 323 U.S. 44 (1944), the Supreme Court held that community property under Oklahoma law, which allowed spouses to elect to have their assets be treated as community property, was not efficacious in causing income of the spouses to be split for income tax purposes. The Court stated that community property systems:

are of two sorts,—consensual and legal. A consensual community arises out of contract. ...In *Poe v. Seaborn*, supra, the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State. 323 U.S. at 46.

Because the Oklahoma community property arose out of contract, the Supreme Court held that “[i]t does not significantly differ in origin or nature from such a status as was in question in *Lucas v. Earl* [, 281 U.S. 111 (1930)], where by contract future income of the spouses was to vest in them as joint tenants.” *Harmon*, 323 at 46. As is well known, the Supreme Court, in essence, held in *Lucas v. Earl* that a taxpayer could not avoid being taxed on income by anticipatorily assigning it, creating the famous “anticipatory assignment of income” tax doctrine. *Lucas*, 281 U.S. at 114-15; see also *Harmon*, 323 U.S. at 52-53.

The Supreme Court stated that Oklahoma had not enacted a new policy as an incident of marriage by adopting its “elect-in” community property system, but it may have done so only to reinforce its conclusion that community property income under the Oklahoma system really arose out of contract (and not, apparently, as a matter of mandatory state law) and, therefore, its taxation was controlled by its decision in *Lucas v. Earl*. In fact, the Supreme Court stated “[w]e...assume that, once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property State.” *Harmon*, 323 U.S. at 47.

Although *Harmon* certainly can be read as indicating that consensual (or “elect-in”) community property is community property “under the community property laws of [a] State” and, therefore, the basis of the surviving spouse’s one-half interest should have its basis determined by Code Sec. 1014(b)(6), *Harmon* predates the enactment of the section and, therefore, may not control that determination. In *McCullum v. United States*, 58-2 USTC ¶ 9957 (CCH) (U.S.D.C. N.D. OK. 1958), however, a U.S. District Court read *Harmon* favorably.

The taxpayers in that case, Mr. and Mrs. J. W. McCollum, elected in 1943 to have their assets constitute community property under the “elect-in” Oklahoma law. In 1945, after the *Harmon* decision, Oklahoma changed its community property regime from a consensual one to a mandatory one. Under the 1945 Oklahoma law, all property, subject to certain exceptions, acquired by a husband and wife after the enactment of the 1945 law (or after the mar-

riage if later) would be community property under Oklahoma law.<sup>2</sup> Oklahoma also made assets which had been elected to be community property under its 1939 “elect-in” law community property under the 1945 version of its “elect-out” law.

Mr. McCollum died after what is now Code Sec. 1014(b)(6) became effective. His wife, who succeeded to his community property interest in a particular piece of land which they acquired after they had elected to fall under the 1939 version of Oklahoma law and before Oklahoma changed its community property law in 1945, took the position that, under the 1939 Internal Revenue Code version of Code Sec. 1014(b)(6), the basis of her one-half interest in the property changed upon her husband’s death. The District Court agreed with the taxpayer. Although by the time Mr. McCollum died Oklahoma had a mandatory or “elect-out” community property system, the decision seems consistent with the notion that Code Sec. 1014(b)(6) applies to consensual or “elect-in” community property; the McCollum community property in question was community property under the Oklahoma mandatory or “elect-out” community property system only because it had become consensual community property under a consensual community property system. In other words, because the property in question was acquired before 1945, it would not have been community property under the 1945 Oklahoma community property law except for the fact that Mr. and Mrs. McCollum had previously elected for it to be community property under the consensual system.

It would seem that the same result which occurred in *McCullum* should occur under the Alaska consensual community property system. Just as under the 1945 Oklahoma community property system, Alaska consensual community property is community property under its state law. In both cases, it seems that the property is community property “under the community property laws of [a] State.”

Another factor suggesting that the basis of the surviving spouse’s one-half interest in consensual community property is determined by Code Sec. 1014(b)(6) is that spouses in community property states usually can vary the nature of their property from community to non-community property and vice versa. For instance, one married person under California law may transmute his or her separate (non-community) property into community property by written agreement.<sup>3</sup> That makes such consensual community property community property under the laws of California, meaning the basis of the surviving spouse’s one-half interest in the property presumably will be determined under Code Sec. 1014(b)(6).<sup>4</sup> There does not seem to be any “policy” reason why Alaska consensual community property should be treated any differently.

Certainly, no such distinction is made or even hinted at in Code Sec. 1014(b)(6) or its legislative history. Because *Harmon* had been decided by the nation’s highest court just four years before, the Congress presumably was aware that

there were both "consensual and legal" (i.e., "elect-out" and "elect-in") community property systems and did not attempt to distinguish the two in Code Sec. 1014(b)(6).

Overall, it seems that Alaska community property may well be treated as "community property...under the community property laws of [a] State" within the meaning of Code Sec. 1014(b)(6) so the basis of the entire property will become its fair market value as of the date of the first spouse to die (or, if applicable, the alternate valuation date under Code Sec. 2032). Clearly, the result is not certain and it may well be that the IRS and the courts will take the contrary view. Thus, a married person or couple should elect into the Alaska community property system only if that form of ownership reflects the type of treatment wanted for those assets even if the property does not fall under Code Sec. 1014(b)(6).

Essentially, the Alaska Community Property Act functions as the Oklahoma Community Property Law did. It is an elect-in community property system. Only to the extent that an Alaska married person or couple elects for property to become Alaska community property will it be treated as such. Alaska married persons (and married non-Alaskans who may consider an Alaska Community Property Trust) will have to determine the extent, if any, they wish to have their property become community property. Only to the extent they so elect, will his, her or their assets become community property under Alaska law. Alaska married persons may effect that by acknowledged instrument or by transferring assets to an Alaska Community Property Trust. A non-Alaska married person may do so only through an Alaska Community Property Trust.

It certainly seems that an asset which is community property under Alaska law is "community property...under the community property laws of [a] State," but a court could hold otherwise. Accordingly, married couples should elect into the Alaska community property system only if that form of ownership reflects their wishes regardless of whether the basis of the surviving spouse's interest in the property will be determined on the death of the first spouse to die under Code Sec. 1014(b)(6). As mentioned above, there are several distinctions between tenancy-in-common property and community property. Moreover, because the Alaska Community Property law's treatment under that section is untested, it may be preferable for the couple, if it is seeking a step-up in basis for all of their wealth when the first spouse dies, to place all of the assets in the name of the spouse who is expected to die first. Unfortunately, that is not always predictable well before that death occurs. Under Code Sec. 1014(e), no change in basis occurs under Code Sec. 1014(a) for property which was given to the decedent within a year of his or her death and is reacquired, directly or indirectly, by the donor.

## Alaska Community Property Trusts

A trust is an Alaska Community Property Trust if:

- (a) one or both spouses transfer property to it,
- (b) the trust expressly declares that some or all the property so transferred is community property under Alaska law;
- (c) an Alaska domiciliary, bank or trust company is a trustee,
- (d) the duties of the Alaska trustee include at least maintaining books and records of the trust in Alaska and preparing or arranging for the preparation of the trust's income tax returns, and
- (e) when and if the assets are distributed during the couple's lifetime, one-half will be distributed to and owned by each spouse.

(See, also, Alaska Stat. 34.75.100(1) (Michie 1998).

## Conclusion

The Alaska community property trust offers practitioners everywhere the option of establishing a form of co-ownership that will equalize the clients' estates (thereby maximizing the use of the lower estate tax rate brackets and exemptions), avoid supervision of the estate administration by probate courts, and possibly effect a substantial increase in the adjusted basis of the surviving spouse in his or her own share of assets previously owned jointly by the couple. Even if the courts refuse to treat the property as eligible for a basis increase under Code Sec. 1014(b)(6), the courts have held that a community property interest in an asset is entitled to a significant discount for lack of marketability, potentially reducing the estate taxes due at each spouse's death. See, e.g., *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982). Thus, the Alaska community property trust is a technique worthy of serious consideration by any client who has a strong, stable marriage of long-standing, and who is comfortable with an equal division of all or certain assets between the spouses.

## ENDNOTES

<sup>1</sup> See, e.g., S. Rep. No. 80-1013, at 1251-1252 (1948).

<sup>2</sup> See generally *Kane v. Commissioner*, 11 T.C. 74 (1948), for a brief history of the Oklahoma community property systems. Oklahoma later repealed its community property law.

<sup>3</sup> See, e.g., CAL. FAM. CODE §§ 850, 852 (West 1994).

<sup>4</sup> "The laws of the state in which you are domiciled govern whether you have community property and community income...Community property is all property acquired by a husband or wife, or both, during their marriage while they are domiciled in a community property state...Community property also includes property that spouses have agreed to convert from separate property to community property." IRS Publication 55, *Community Property*.