

MEMORANDUM

To: Ronald J. Scalise Jr., Reporter of the Uniform Community Property Disposition at Death Act Committee

CC: Bruce M. Stone
Turney B. Berry
David M. English

From: Juan C. Antúnez, Observer, Miami, Florida

Subject: Nature of Community Property in Common Law Jurisdictions Adopting the Uniform Community Property Disposition at Death Act (“UCPDDA”)

Date: November 19, 2020

For the reasons discussed below, the drafting committee for the UCPDDA should include the following provision in the text of the act explicitly addressing a state property-law question with significant federal income tax implications. Namely, what is the “character” of property in common-law jurisdictions to which the act applies? In other words, does a change of domicile from a community-law jurisdiction to a common-law jurisdiction transmute the character of community property subject to the UCPDDA to separate property, or does such property retain its character as community property? The following proposed text answers that question definitively:

The property to which this [act] applies retains its character as community property under the laws of this state, including for purposes of the application of s. 1014(b)(6) of the Internal Revenue Code of 1986, 26 U.S.C. s. 1014(b)(6).

As explained in *Section 1014(b)(6) and the Boundaries of Community Property* (see attached copy),¹ the IRS will generally adhere to state law property-law characterizations especially – as in the case of the UCPDDA – where the property-law characterization applies with equal force to all married couples (i.e., all couples moving from community property jurisdictions to common law jurisdictions). Whether an adopting state chooses to explicitly retain the community-property character of property subject to the UCPDDA – or not – has significant federal tax implications.

The possible disparate tax outcomes arising out of this fundamental property-law question (i.e., what is the “character” of property subject to the act?), is illustrated in the following fact pattern. Joan and Clark Johnson, a married couple, moved to Florida, a common law jurisdiction, from Texas, a community property jurisdiction. The couple holds joint title to an appreciated investment asset acquired years ago while they lived in Texas, to which the UCPDDA applies under Florida law, with a current tax basis of \$100,000 and a \$1 million fair market value. Clark dies, and the asset is liquidated at year’s end for its \$1 million fair market value.

¹ [Ware, Jeremy T. \(2005\) "Section 1014\(b\)\(6\) and the Boundaries of Community Property," *Nevada Law Journal*: Vol. 5 : Iss. 3 , Article 5.](#)

If the property-law character of the asset was transmuted from community property to separate property when the couple changed their marital domicile from Texas to Florida, section 1014(a)(1) of the Internal Revenue Code results in a \$550,000 income tax basis to Joan. Clark's basis in his half of the asset increases from the original \$50,000 to \$500,000 (the date of death value), plus Joan's basis in her half of the property remains \$50,000. The subsequent sale of the property produces a \$450,000 gain (\$1 million amount realized less \$550,000 basis) and a **tax liability of \$107,100** ($\$450,000 \times 23.8$ percent (20 percent long-term capital gains tax rate plus 3.8 percent unearned income tax rate)). In contrast, if the asset retained its character as community property under Florida law because it is subject to the UCPDDA, section 1014(b)(6) of the Internal Revenue Code results in a \$1 million income tax basis to Joan due to the step-up in basis. In light of that adjustment, the subsequent sale of the asset produces zero gain (\$1 million amount realized less \$1 million basis) and **zero tax liability**.

* * * * *

SECTION 1014(B)(6) AND THE BOUNDARIES OF COMMUNITY PROPERTY

Jeremy T. Ware*

One of the most widely used tax loopholes in the Internal Revenue Code is the § 1014 step up in basis provision. This provision typically allows taxpayers receiving property from a decedent to increase the basis of such property to the fair market value at the time of death.¹ The residents of the community property states are further entitled to a “full step up” via § 1014(b)(6), which allows a basis step up not only for the decedent’s half of community property, but also for the surviving spouse’s half of the same community property. This step up is, perhaps, the primary federal tax advantage of community property.

In light of these tax advantages, it is important to understand the boundaries of community property for purposes of § 1014(b)(6). Community property law has many contours and confusions that cloud the picture of how certain property will be treated by the IRS. This article seeks to explore eight major areas of possible confusion to determine how the Service and the courts might treat such property under the full step up in basis provision. These areas are: (1) Commingling of separate and community property; (2) Agreements to live in universal community; (3) Adoption by a common law state of the Uniform Disposition of Community Property Rights at Death Act; (4) Changes in marital domicile from a community property state to a common law state; (5) Community property with right of survivorship; (6) The Alaska Community Property Act’s elective regime as it pertains to Alaska residents; (7) Community property trusts created by community property state residents; and (8) Alaska community property trusts created by nonresidents. Though the Service has not spoken clearly on all of these points, this article seeks to sharpen the boundary lines of what is or should be community property for purposes of § 1014(b)(6).

INTRODUCTION TO § 1014

As briefly noted above, section 1014 serves as one of the largest tax loopholes in the Internal Revenue Code (“Code”). Subsection 1014(a) provides that, generally, “the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall . . . be . . . the fair market value of the property at the date of the decedent’s

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¹ I.R.C. § 1014(a)(1) (2001).

death”² Thus, the appreciation on most property passing from decedents entirely escapes federal income taxation. This is obviously a major benefit in a world where, it is often said, the only sure things are death and taxes.³

Residents in community property states enjoy a further advantage, known generally as the “full step up.” Usually, when spouses own a piece of property jointly and one of them dies, only the decedent’s half of the property would be stepped up.⁴ But § 1014(b)(6) provides that, for purposes of § 1014(a), property acquired or passing from the decedent includes,

property which represents the *surviving* spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if 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.⁵

In other words, the basis of the whole of such community property will be stepped up, not just the decedent’s half.⁶ Thus, residents in community property states enjoy not only the advantage of the § 1014 step up, but also a double application of the step up, assuming § 1014(b)(6) is satisfied.⁷

To understand why Congress would treat community property state residents so favorably, one must briefly explore the history of marital property in the United States. The purpose behind § 1014(b)(6) illuminates a discussion of what property may qualify for this provision, and what the future of the provision will or should be.

Section 1014(b)(6) applies to all decedents dying after December 31, 1947. In the late 1940s, most marital property was earned by the husband. Thus, in a common law state, nearly all of a couple’s property may have legally been the separate property of the husband. If the husband dies first, which is probable, nearly all of the couple’s property would receive a basis step up.⁸ In a community property state, however, the husband’s earnings are community property.⁹ Therefore, at death, he could probably bequeath only half of the marital property, and so only half of the couple’s property would receive the step up. An inequality thus existed between common law and community property states.

Section 1014(b)(6) was intended to remedy this inequality. In the words of the Ninth Circuit in *Willging v. United States*, “Section 1014(b)(6) was designed to equalize the incidence of taxation between community-property and common-law states.”¹⁰ Importantly, for our purposes, the court goes on to add that § 1014(b)(6) was not designed, “to provide a special benefit to com-

² *Id.*

³ Benjamin Franklin, *Letter to Jean-Baptiste Leroy* (Nov. 13, 1789), reprinted in *THE OXFORD DICTIONARY OF QUOTATIONS* (5th Ed. 1999).

⁴ I.R.C. § 1014(a)(1) (2001).

⁵ *Id.* § 1014(b)(6).

⁶ *Id.*

⁷ *Id.*

⁸ I.R.C. § 1014(a)(1), (b)(1).

⁹ See, e.g., CAL. FAM. CODE § 760 (West 2004).

¹⁰ *Willging v. United States*, 474 F.2d 12, 14 (9th Cir. 1973). *Accord* *Bath v. United States*, 323 F.2d 980, 981 (5th Cir. 1963) (quoting *Bath v. United States*, 211 F.Supp. 368, 370 (S.D. Tex. 1962)). See also S.REP. NO. 80-1013, at 29 (1948).

munity-property taxpayers.”¹¹ Clearly, section 1014(b)(6) today acts primarily as a tax advantage for those in community property states, because property is not always so concentrated in the husband’s hands as when § 1014(b)(6) first became effective. The current reaction to this fact will be discussed later.¹²

An individual can access the modern-day tax advantages of the full step up if property is considered community property for purposes of § 1014(b)(6). To understand what property will be considered community property in the context of 1014(b)(6) one must first see how federal taxes are imposed.

In summarizing the procedure of tax imposition, the United States Tax Court held that:

It has been established that what constitutes an interest in property held by a person within a State is a matter of State law . . . In *Commissioner v. Estate of Bosch*, . . . the Supreme Court held that State law as announced by the highest court of the State is to be followed. “If there is no decision by that court, then federal authorities must apply what they find to be the state law . . .” On the other hand, once property rights are determined under State law, Federal law is utilized to decide the tax consequences.¹³

This fits especially well with § 1014(b)(6), which only requires that property be considered community property “under the community property laws of any State.” Thus, under the plain language of the statute, if property is community property under the relevant state’s law, then presumably § 1014(b)(6) should provide a full step up for such property.¹⁴ Such language suggests a straightforward statutory inquiry into whether § 1014(b)(6) applies, but in reality its application has been much more complex.

A. *Commingling of Separate and Community Property*

Under most state laws, commingling of separate and community property typically transmutes the separate property into community property.¹⁵ But will this taxpayer-created community property be treated as such for purposes of § 1014(b)(6)? The IRS has not spoken clearly, but it would seem that this type of community property does qualify for the full step up.

For example, commingling occurs when a spouse deposits her community property paychecks into a regularly used checking account that also contains her own separate property.¹⁶ Such separate property may derive from an inheritance, property acquired before marriage, or any number of other sources.¹⁷ Over the course of time, the community and separate property become so intermixed that it is impossible to distinguish what is separate or community.

Though the effect of commingling varies by state, this Louisiana definition is typical: “commingling of separate and community property in a bank

¹¹ *Willging*, 474 F.2d at 14.

¹² See Conclusion *infra*.

¹³ *Estate of Young v. Comm’r*, 110 T.C. 297, 300 (1998) (internal citations omitted) (quoting *Comm’r v. Estate of Bosch*, 387 U.S. 456, 465 (1987)).

¹⁴ *But see Yiatchos v. Yiatchos*, 376 U.S. 306 (1964) (rare case where federal law pre-empts state law involving federal bonds).

¹⁵ See, e.g., *Stoutz v. United States*, 324 F.Supp. 197, 203 (E.D. La. 1970) (internal citations omitted), *aff’d*, 439 F.2d 1197 (5th Cir. 1971).

¹⁶ *Id.*

¹⁷ See, e.g., CAL. FAM. CODE § 770.

account destroys the identity of the separate funds. . . . The separate character of money commingled with community funds remains intact only if the amount of community funds commingled constitutes an insignificant percentage of the total fund."¹⁸ Some states further require that the community funds be indistinguishable from the separate funds for commingling to occur.¹⁹ But putting aside specific state requirements, because commingling undoubtedly and explicitly creates community property in some states,²⁰ the question arises whether the IRS will recognize the changed character of this property for purposes of § 1014(b)(6). The IRS has not taken a discoverable position on the matter, but a number of factors suggest that the Service will accept, perhaps begrudgingly, such transmutations for § 1014(b)(6) purposes.

First, the courts seem to presume the validity of commingling transmutations for other federal tax purposes.²¹ For example, in *Sweeney v. Commissioner* the predecessor of the Tax Court encountered a classic commingling situation concerning a Washington couple.²² The IRS argued that various properties of a deceased husband were his separate property, and were therefore taxable at 100% of their value for federal estate tax purposes.²³ The surviving wife argued that the property had been commingled in a common account (as well as transmuted by agreement) and had thus become community property, consequently exposing only 50% of the property to the estate tax.²⁴ The court wrote,

[W]here separate and community property have become so intermingled, commingled and merged as to make segregation difficult or impossible, the whole is treated as community property . . . In consideration both of the commingling of the property and of the express agreement between the parties, we hold that the entire property formerly owned by the decedent and [the wife of the decedent] . . . was community property.²⁵

The estate tax was subsequently assessed on approximately half the value the IRS had argued for.²⁶ The Tax Court came to a similar conclusion regarding the federal gift tax in *Damner v. Commissioner*.²⁷ So for purposes of the federal estate and gift taxes, commingling seems to be an effective means of transmutation of separate property into community property. While there are no cases specifically addressing the effectiveness of commingling transmutations for § 1014(b)(6) purposes, the cases above suggest that the courts would find commingling to be an effective means of transmutation for purposes of this section of the federal Internal Revenue Code as well.

¹⁸ *Id.*

¹⁹ *See, e.g., Sweeney v. Comm'r*, 15 B.T.A. 1287, 1292-93 (1929).

²⁰ *See, e.g., Stoutz*, 324 F.Supp. at 203; *Sweeney*, 15 B.T.A. at 1292-93 (Washington); *Houska v. Houska*, 512 P.2d 1317, 1319 (Idaho 1973); *Damner v. Comm'r*, 3 T.C. 638, 642 (1944) (California).

²¹ *Sweeney*, 15 B.T.A. at 1287.

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 1287-93.

²⁵ *Id.* at 1292-93 (internal citations omitted).

²⁶ *Id.* at 1293.

²⁷ *Damner v. Comm'r*, 3 T.C. 638, 642 (1944) (California).

Second, commingling transmutations seem to fit within the plain meaning of the statute. Section 1014(b)(6) only requires that property be considered community property “under the community property laws of any State . . .”²⁸ Commingling clearly transmutes the character of separate property to community property in certain states.²⁹ A plain meaning application of § 1014(b)(6) seems to suggest that commingling would be an effective transmutation under the statute as long as the property were considered transmuted under state law. Thus, the full step up should occur.

Indeed, the IRS seems to adhere strongly to the plain meaning of § 1014(b)(6). In Revenue Ruling 87-98, the Service addressed a situation in which a couple domiciled in a community property state took title to real property as joint tenants with rights of survivorship, a common law form of separate property ownership.³⁰ This raised a presumption of transmutation from community to separate property, under state law.³¹ But the IRS noted that because the couple had indicated in their wills that they considered the property to be community property, the presumption was overcome under state law.³² Even though the title to the property indicated separate ownership, the IRS held that “[b]ecause it is community property under state law, it is also community property within the meaning of section 1014(b)(6).”³³ So even in a case where the IRS could argue that the property was separate property according to the real property titling, it adhered strictly to the state law characterization of the property as community and allowed the full step up. Likewise, it would seem that where state law found commingled separate property to be transmuted to community property, the IRS might very well allow the application of § 1014(b)(6) to such property.

Third, commingling is regularly recommended by estate planners as a means of transmuting separate property into community property for purposes of § 1014(b)(6).³⁴ “Section 1014 provides an advantage to community property interests not available to any other type of marital property . . . For citizens living in community property states, the conversion of highly appreciated separate property can be achieved by commingling of funds,”³⁵ thus tapping into the full step up advantage. This commingling process is simply assumed to be a viable method of transmutation.³⁶

Fourth, it is almost certain that couples are commingling separate property every day and later claiming the full step up for all of the transmuted property,

²⁸ I.R.C. § 1014(b)(6).

²⁹ See, e.g., *Stoutz v. United States*, 324 F.Supp. 197, 203 (E.D. La. 1970) (Louisiana); *Sweeney*, 15 B.T.A. at 1292-93 (Washington); *Houska v. Houska*, 512 P.2d 1317, 1319 (Idaho 1973) (Idaho); *Danner*, 3 T.C. at 642 (California).

³⁰ 1987-2 C.B. 206.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ See, e.g., Edward F. Koren, Taso M. Milonas & William B. Roberts, *Types of Property Ownership, Community Property – Basis Adjustment*, in EDWARD F. KOREN, *ESTATE AND PERSONAL FINANCIAL PLANNING* § 10:52 (2003); Gary C. Randall, *Estate Planning and Community Property*, 28 IDAHO L. REV. 807, 815 (1991/1992).

³⁵ Koren, *supra* note 34, at § 10:52.

³⁶ See, e.g., Randall, *supra* note 34, at 815.

whether or not they commingled for the sole purpose of claiming the full step up. The practice must be widespread, and yet the Service has not addressed it.

The IRS's silence suggests acquiescence, at least for the present, though this is by no means certain. The case law, though tangential, seems to suggest that commingling would be an effective transmutation for purposes of § 1014(b)(6). The plain meaning of the statute also seems to favor allowance of the practice. And the ubiquitous use of commingling would presumably invoke a response by the IRS if it did not agree with the practice.

A number of reasons for acquiescence suggest themselves. Perhaps the IRS feels that the cost of enforcement concerning such a widespread practice is prohibitive. Perhaps the potential tax revenue is simply not large enough to justify the additional expenditures for enforcement. The IRS may not wish to be viewed as attacking the longstanding practice of giving unpropertied spouses a community share in transmuted property. It may believe that such transmutation could be easily achieved in other ways or that the courts would rule against it based on the extant case law.³⁷ Or it may simply be that the IRS believes that § 1014(b)(6) should apply to such transmutations, based on the plain meaning of the statute.

The Service does, of course, have a revenue interest in denying the full step up to as much property as possible, within the bounds of the Internal Revenue Code. This is especially so in the case of commingling, and other situations to be discussed *infra*, because the power to create community property lies in the hands of taxpayers and not immediately with the state itself. However, it would seem that the Service is acquiescing for now. In any case, because the Service's silence leaves the issue of commingling unclear, it is not advisable to use this method for highly appreciated separate property. A couple wishing to ensure the full step up might wish to use the slightly safer method of a transmutation agreement to solidify their claim to the full step up. ¶

The Service has not clarified its position on the effectiveness of commingling transmutations for purposes of § 1014(b)(6), but a number of factors seem to suggest that it is forgiving in the matter. Indeed, it seems that such transmutations are effective anyway, regardless of the Service's position, because they fall within the plain language of the statute. However, it will take a clear statement from either the IRS or the courts to end the debate.

B. *Agreements to Live in Universal Community*

Similar to commingling, couples in some community property states can enter into agreements to live in universal community that effectively transmutes all their separate property to community property under state law.³⁸ Again, the IRS has not spoken clearly on whether it considers such transmutations effective for purposes of § 1014(b)(6). But even more so than with commingling, there is evidence to suggest that the IRS accepts such agreements as effective transmutations for § 1014(b)(6) purposes.

In a typical universal community agreement, husband and wife execute an agreement to transmute all of their current separate property and even any

³⁷ See *supra* Part A.

³⁸ See, e.g., CAL. FAM. CODE § 850(b) (West 2004).

future separate property they may acquire into community property. In many states, this is unquestionably a permissible means of transmutation of separate property into community property.³⁹ Similar to commingling, with these agreements the taxpayer has the power to create more community property than the state would otherwise create, yet community property created by such agreements is clearly community property "under the community property laws of any State . . ."⁴⁰ Again, it is unclear how the IRS will regard such agreement-created community property, but a number of factors suggest that the Service does or will accept universal community agreements as a valid means of transmuting separate property to community property for purposes of § 1014(b)(6).

First, as with commingling, the case law suggests that the courts will consider such agreements effective for purposes of the full step up in basis. While the issue has yet to be addressed directly, courts generally find such agreements effective for purposes of other federal taxes.⁴¹ For instance, in *Bank of America National Trust and Savings Association v. Commissioner*, the predecessor to the Tax Court found a universal community agreement transmutation valid for purposes of the federal estate tax because the agreement effectively transmuted the property under California law.⁴² The Tax Court also came to a similar conclusion regarding the federal gift tax in *Damner v. Commissioner*.⁴³ Again, while these cases do not deal with § 1014(b)(6), they seem to suggest that for general federal tax purposes, universal community agreements are an effective means of transmuting separate property to community property.

Second, the Uniform Disposition of Community Property Rights at Death Act regards separate property transmuted by agreement to be community property.⁴⁴ The Conference of Commissioners on Uniform State Laws believes such transmutations should be effective generally, suggesting that such transmutations should be effective for purposes of § 1014(b)(6).⁴⁵

Third, as with commingling, universal community agreements are regularly recommended by estate planners as a means of transmuting separate property into community property for purposes of § 1014(b)(6).⁴⁶ This suggests that the practice is common and that the IRS does not wish to contest it.

³⁹ See, e.g., TEXAS CONST. art. XVI, § 15 (1999); *Sweeney v. Comm'r*, 15 B.T.A. 1287, 1292-93 (1929) (Washington); *Aronow v. Comm'r*, 29 T.C.M. (CCH) 1079 (1970) (California); *Stockdale v. Stockdale*, 643 P.2d 82, 85-86 (Idaho Ct. App. 1982).

⁴⁰ I.R.C. § 1014(b)(6).

⁴¹ See, e.g., *Bank of Am. Nat'l Trust & Sav. Assoc. v. Comm'r*, 43 B.T.A. 695, 698 (1941).

⁴² *Id.*; *Sweeney*, 15 B.T.A. at 1292-93 (federal estate tax); *Estate of Young v. Comm'r*, 110 T.C. 297, 303 (1998) (holding that in general, property may be transmuted by agreement for purposes of the federal estate tax).

⁴³ *Damner v. Comm'r*, 3 T.C. 638, 642 (1944).

⁴⁴ UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT § 1 (Comment) (1971) ("Subsection (1) is designed to cover . . . any property which was not originally community property but became such by agreement . . .").

⁴⁵ *Id.*

⁴⁶ See, e.g., W. Peter Burns, *Marital Estate Planning*, 189 PLI/Est 321, 329-31 (Sept./Nov. 1989); Randall, *supra* note 34, at 815; Carl J. Rasmussen, *Divorce Provisions in Opt-In Marital Property Agreements*, 67-APR WIS. LAW. 15, 15 (1994); Sarah Ann Smith, *The Unique Agreements: Premarital and Marital Agreements, Their Impact Upon Estate Planning, and Proposed Solutions to Problems Arising at Death*, 28 IDAHO L. REV. 833, 873-74

Indeed, one commentator notes that “[E]ven though residents of the nine community property states may opt-out of or opt-in to the system at will, [for instance via universal community agreements,] the Service has not attempted to deny them the separate reporting of taxable income, nor the full basis adjustment of I.R.C. § 1014(b)(6).”⁴⁷ This inaction suggests that the IRS believes § 1014(b)(6) should be applied to universal community agreements, though this is not certain.

Fourth, similar to commingling, the plain meaning of § 1014(b)(6) allows application of § 1014(b)(6) where property has been transmuted by agreement. Since such transmutations are effective under state law, they should also be effective for purposes of § 1014(b)(6). Also, the discussion above of Revenue Ruling 87-98⁴⁸ supports the position that the Service will allow the full step up for agreement-transmuted property. Such property is community property “under the community property laws of any State . . . ,”⁴⁹ and the Service seems to read this language literally.⁵⁰

Finally, and perhaps most importantly, two other IRS documents strongly suggest that the Service accepts universal community agreement transmutations for purposes of § 1014(b)(6). In Revenue Ruling 77-359, the Service ruled on the effect of such an agreement “for Federal income tax purposes” for couples domiciled in Washington state.⁵¹ Also, the Service noted that the Supreme Court of Washington has held that such agreements do effectively transmute separate property to community property.⁵² “Accordingly,” it wrote:

where a husband and wife residing in the State of Washington agree in writing that all presently owned property and all property to be acquired thereafter, both real and personal, will be community property, such agreement changes the status of presently owned separate property and subsequently acquired separate property to community property.⁵³

While the statement was issued under the regulations to Code § 61, it addresses the validity of such agreements “for Federal income tax purposes.”⁵⁴ Since § 1014(b)(6) is part of the income tax provisions of the Code, the ruling demonstrates that the IRS accepts universal community agreements in the context of § 1014(b)(6).

Further, it would seem that the decision in Revenue Ruling 77-359 is in keeping with the plain language of § 1014(b)(6). The law of the state of Washington, as with many other community property states, considers such agreement-transmuted property to be community property, and thus it should be so considered for purposes of § 1014(b)(6), which only requires that property be

(1991/1992); Gerald B. Treacy, Jr., *Planning to Preserve the Advantages of Community Property*, 23 EST. PLAN. 24, 26, 29 (1996).

⁴⁷ David G. Shaftel & Stephen E. Greer, *Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents*, SD36 ALI-ABA 1, June 10-11, 1999, at 12-13.

⁴⁸ See *supra* Part A.

⁴⁹ I.R.C. § 1014(b)(6).

⁵⁰ Rev. Rul. 87-98, 1987-2 C.B. 206.

⁵¹ 1977-2 C.B. 24.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

considered community property "under the community property laws of any State" This Revenue Ruling indicates that the Service would find that such transmutations by agreement fit into the plain meaning of § 1014(b)(6).⁵⁵

This plain meaning interpretation is bolstered by a Private Letter Ruling issued by the Service in 1999. Husband and wife X and Y held stock in an account under X's name.⁵⁶ Subsequently, "X and Y executed a marital property declaration and agreement confirming that all property they held, either separately or jointly, was community property."⁵⁷ Y then died and a county superior court found the stock to be community property, based on state law.⁵⁸ The IRS ruled that the survivor, X, was entitled to the full step up under § 1014(b)(6).⁵⁹ Furthermore, the Service noted that this result would not stand if the court order concerning the character of the stock was reversed.⁶⁰ Though this is a Private Letter Ruling, both the result and the cautionary note indicate that the Service considers universal community agreements to be an effective means of transmuting separate property to community property for purposes of § 1014(b)(6), as long as the transmutation is valid under state law.

The five factors above generally suggest that the IRS will allow universal community agreements to effectively transmute separate property to community property for purposes of § 1014(b)(6). First, the case law suggests that the courts would so hold. Second, the Conference of Commissioners on Uniform State Laws also seems to be in agreement on the issue. Third, the practice seems to be both widespread and widely recommended. Thus, the Service's inaction suggests that it will allow such transmutations for purposes of § 1014(b)(6). Fourth, the plain language of § 1014(b)(6) seems to include such agreement-transmuted property. Finally, both an IRS Revenue Ruling and a Private Letter Ruling seem to indicate that the Service will find such transmutation agreements valid for purposes of § 1014(b)(6). And, as with commingling, this result appears to be in keeping with the plain meaning of the statute. Universal community agreements do transmute separate property to community property "under the community property laws of any State."⁶¹

⁵⁵ In an important cautionary note, the Service added, "To the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns." *Id.* (quoting *Comm'r v. Harmon*, 323 U.S. 44 (1944), 1944 C.B. 166). *Harmon* is discussed at length in the section on the Alaska Community Property Act. This ruling flies in the face of basic community property law. For instance, IDAHO CODE § 32-906(1) (1980) states that income from separate property is community property (and thus could be split). The issue seems unresolved by the Service. See the discussion *infra* on the current applicability of *Harmon*.

⁵⁶ Priv. Ltr. Rul. 99-17-025 (Apr. 30, 1999).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ I.R.C. § 1014(b)(6) (2001).

C. Adoption of the Uniform Disposition of Community Property Rights at Death Act

Though commingling and universal community agreements present a relatively straightforward argument for a full step up under 1014(b)(6), the outcome is less clear when taxpayers move from a community property state to a common law state. This section will address community property taken into a common law state that has adopted the Uniform Disposition of Community Property Rights at Death Act (Uniform Act).

In common law states that have adopted the Uniform Act the full step up for couples moving to those states may be preserved. In such situations, the IRS seems to follow the plain language of § 1014(b)(6) in finding that the full step up is allowed,⁶² though this is a rather surprising result, as shall be seen.

The Uniform Act, as adopted in fourteen common law states,⁶³ generally provides that property which is considered community property in a community property jurisdiction, when brought into a Uniform Act state, will be treated like community property at the death of the first spouse to die.⁶⁴ Specifically, the act applies to "all personal property, wherever situated . . . which was acquired as or became, and remained, community property under the laws of another jurisdiction," as well as any part of any personal property or real property in the common law jurisdiction in question that was acquired with "the rents, issues, or income of, or the proceeds from, or in exchange for, that community property" or is "traceable to that community property."⁶⁵ The Uniform Act provides that at the death of the first spouse, half of the property belongs to the survivor and half "is subject to testamentary disposition [of the decedent] or distribution under the laws of succession of [the common law] State."⁶⁶ Thus, property that was community property in another state and is brought into a Uniform Act state, or used to purchase property in a Uniform Act state, is still treated like community property at death.

However, the Uniform Act does not state that it preserves the community character of such property; it only causes it to be disposed of in a similar manner at death. Furthermore, the Uniform Act is only effective at death.⁶⁷ It does not purport to affect property during the lives of the spouses. Thus, the situation of former community property in Uniform Act states raises the issue

⁶² 1993 WL 1609164 (IRS FSA).

⁶³ Adopted in Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Virginia, and Wyoming. ALASKA STAT. §§ 13.41.005 to 13.41.055 (Michie 1984); ARK. CODE ANN. §§ 28-12-101 to 28-12-113 (Michie 1981); COLO. REV. STAT. §§ 15-20-101 to 15-20-111 (1973); CONN. GEN. STAT. ANN. §§ 45a-458 to 45a-466 (West 1985); FLA. STAT. ANN. §§ 732.216 to 732.228 (West 1992); HAW. REV. STAT. §§ 510-21 to 510-30 (1973); KY. REV. STAT. ANN. §§ 391.210 to 391.260 (Michie 1974); MICH. COMP. LAWS ANN. §§ 557.261 to 557.271 (West 1975); MONT. CODE ANN. §§ 72-9-101 to 72-9-120 (1989); N.Y. EST. POWERS & TRUSTS §§ 6-6.1 to 6-6.7 (1981); N.C. GEN. STAT. §§ 31C-2 to 31C-12 (1981); OR. REV. STAT. §§ 112.705 to 112.775 (1973); VA. CODE ANN. §§ 64.1-197 to 64.1-206 (Michie 1982); and WYO. STAT. ANN. §§ 2-7-720 to 2-7-729 (Michie 1985).

⁶⁴ UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT §§ 1, 3 (1971).

⁶⁵ *Id.* § 1.

⁶⁶ *Id.* § 3.

⁶⁷ UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT §§ 1, 3.

of how the property will be treated at death. It is unclear whether the IRS will consider the property community for purposes of 1014(b)(6).

Leading commentators are split on the issue. Jonathan G. Blattmachr, et al., note that "no relevant authority appears to exist, [but that] section 1014(b)(6) should determine the basis of the surviving spouse's one-half interest in property covered by the Uniform Act."⁶⁸ William A. Reppy, Jr., however, doubts that the Uniform Act will preserve the full step up, since the act does not explicitly claim to preserve the community character of the property in question.⁶⁹

Though the issue of preservation of community character is probably central, the fact that the Uniform Act is only operative at death seems irrelevant. If the Uniform Act causes property to be community property at the moment of death, its character during the life of the decedent should not matter. In *Murphy v. Commissioner*, a California couple converted real estate from community property to tenancy in common and sought to invoke § 1014(b)(6).⁷⁰ The Ninth Circuit held that § 1014(b)(6) does not apply to property that was, at some past time, held as community property.⁷¹ *Murphy* thus stands for the proposition that the only characterization of property that matters for § 1014(b)(6) purposes is the characterization at death. Likewise, commingling and universal community agreements appear to transmute separate property to community property.⁷² But it does not seem to matter that the property was separate property at some previous point. What matters is that property is community property at the time of death. Thus, it would seem that the fact that the Uniform Act is only operative at death is irrelevant. What does matter is whether the Service will characterize property controlled by the Uniform Act as community property under § 1014(b)(6).

While the IRS has yet to squarely address the issue, there is some authority indicating the Service will allow the full step up for former community property in Uniform Act states.⁷³ Indeed, this was the conclusion reached in a Field Service Advisory (FSA) treating property held in the Uniform Act state of Oregon.⁷⁴ The FSA presented a situation in which a couple had sold their community property residence in California and applied the proceeds towards a replacement residence held jointly in the non-community property state of Oregon.⁷⁵ Since Oregon had enacted the Uniform Act, half of the property would go to the survivor and half would be subject to disposition by the decedent.⁷⁶ Surprisingly, the FSA stated that "under Oregon law, property to which the Uniform Act applies retains its character as community property although the

⁶⁸ Jonathan G. Blattmachr et al., *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & TR. J. 615, 628 (1999).

⁶⁹ E-mail from William A. Reppy, Professor of Law, Duke University School of Law to Jeremy T. Ware (Nov. 20, 2003) (on file with author).

⁷⁰ 342 F. 2d 356, 358 (9th Cir. 1965).

⁷¹ *Id.* at 359.

⁷² See *supra* Part A.

⁷³ 1993 WL 1609164 (IRS FSA).

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

property is situated in Oregon, a noncommunity property state.”⁷⁷ Furthermore, the FSA stated that “[in] all cases, the controlling factor is the characterization of the property under state law,” which in this case allowed the full step up.⁷⁸

This is a surprising result because the Uniform Act does not purport to preserve the character of community property as community property. The Uniform Act only allows the property to be disposed of at death in a manner similar to community property in the adopting common law state.⁷⁹ And yet this FSA held that property controlled by the Uniform Act which is disposed of in this manner has actually retained its community character and is entitled to the full step up.⁸⁰ In other words, the IRS seems to be saying that if former community property is disposed of as community property, its character as community property has been preserved for purposes of § 1014(b)(6).

Though this FSA indicates a forgiving IRS stance on property covered by the Uniform Act, great caution should be taken in relying on it. First, as an FSA, it cannot be used as precedent.⁸¹ Second, as discussed, its reasoning seems faulty. Just as commingling and universal community agreements probably will allow the full step up because they transmute separate property to community property under state law, the Uniform Act probably should not allow the full step up, because property under the Uniform Act does not seem to retain its community character. However, at present, the IRS has at least indicated that it does consider the Uniform Act to preserve the character of community property upon a move to an adopting common law state, and thus may allow the application of § 1014(b)(6).

D. Changes in Marital Domicile from a Community Property to a Common Law State

Though the IRS seems to liberally permit the application of 1014(b)(6) with commingling, universal community agreements, and perhaps even the Uniform Act, this has not been the case with changes in marital domicile from a community property to a common law state.⁸² As with commingling and universal community agreements, the characterization of property under state law is exceedingly important, if not dispositive, so the effect of such marital domicile changes on the state law characterization of community property must be explored before progressing to the probable IRS response to this issue.

A move from a community property to a common law state generally has one of two effects. The common law state may hold that when a couple moves to the state, or exchanges separate property there, their community property automatically transmutes to some form of separate common law co-ownership.⁸³ In these cases, the IRS will probably not allow the full step up. Alter-

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT § 3 (1971)

⁸⁰ 1993 WL 1609164 (IRS FSA).

⁸¹ *Id.*; I.R.C. § 6110(k)(3).

⁸² *See, e.g.*, Rev. Rul. 68-80, 1968-1 C.B. 348.

⁸³ *See, e.g.*, Quintana v. Ordonez, 195 So.2d 577, 580 (Fla. Dist. Ct. App. 1967) (But the court did seem to suggest that if the community property had not been exchanged in Florida,

natively, some common law states preserve the community property character of transported property.⁸⁴ In these states the IRS will arguably allow the full step up, though this issue is still unclear.

1. Common Law States Requiring a Change in Ownership Form for Community Property

The majority rule is that initial ownership of moveable property is determined by the law of the marital domicile at the time of acquisition.⁸⁵ For instance, in the leading case of *Quintana v. Ordone* a husband domiciled in Cuba, which was a community property jurisdiction at that time, purchased stock with money he earned in Florida, a common law jurisdiction.⁸⁶ The court wrote,

Whether the source of the purchase price of the stock was from enterprises within Cuba or Florida is not material. What is material and not in conflict is that the husband and wife were domiciled in Cuba at the time of the acquisition of the stock . . . by the almost unanimous authority in America, the "Interests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicile of the parties when the movables are acquired."⁸⁷

Under *Quintana*, if a couple is domiciled in a community property state and acquires moveable property in a common law state, the property will still be community property, assuming the state of domicile considers it to be such.⁸⁸ Real property characterization, however, is typically governed by the law of the situs of the property.⁸⁹ The situation is more complicated, however, when moveable community property is transported into a common law state upon a change of domicile.

Some states will force a transmutation of community property to some form of separate common law co-ownership when a couple moves from a community property state to a common law state or subsequently exchanges their community property in that state.⁹⁰ Under community property law theory, transported community property, or any property for which it is exchanged,

it might have remained community property); *Stone v. Sample*, 63 So.2d 307, 308-09 (Miss. 1953); *Depas v. Mayo*, 1848 WL 4002 at *4 (Mo. 1848); *In re Hunter's Estate*, 236 P.2d 94, 95 (Mont. 1951) (in dicta); *Rozan v. Rozan*, 129 N.W.2d 694, 707 (N.D. 1964); *Edwards v. Edwards*, 233 P. 477, 485 (Okla. 1924); 40 Md. Atty. Gen. Op. 526 (1955).

⁸⁴ See, e.g., *Dunbar v. Bejarano*, 358 P.2d 866, 868-69 (Colo. 1961).

⁸⁵ See, e.g., *Quintana*, 195 So.2d at 579. But there are a few rare cases where courts have adopted a significant relationships test, instead, to determine the applicable law. See, e.g., *In re Estate of Crichton*, 228 N.E.2d 799, 805-06 (N.Y. 1967); *Pacific Gamble Robinson Co. v. Lapp*, 622 P.2d 850, 855 (Wash. 1980).

⁸⁶ *Quintana*, 195 So.2d at 578.

⁸⁷ *Id.* at 579 (quoting RESTATEMENT, CONFLICT OF LAWS § 290 (1934)).

⁸⁸ *Id.*

⁸⁹ *Id.* at 578. The approach for moveable property differs from that for real property, where the characterization is typically governed by the law of the situs of the property. See, e.g., *Stone*, 63 So.2d at 308-09.

⁹⁰ See, e.g., *Quintana*, 195 So.2d at 580; *Stone*, 63 So.2d at 308-09; *Depas v. Mayo*, 1848 WL 4002 at *4 (Mo. 1848); *In re Hunter's Estate*, 236 P.2d 94, 95 (Mont. 1951) (in dicta); *Rozan v. Rozan*, 129 N.W.2d 694, 707 (N.D. 1964); *Edwards v. Edwards*, 233 P. 477, 485 (Okla. 1924); 40 Md. Atty. Gen. Op. 526 (1955).

should remain community property.⁹¹ But common law state courts often do not understand community property sufficiently to preserve the community property character of such property, or do not wish to. This issue usually only arises when a couple actually exchanges community property for other property within the common law state. Because courts address the issue primarily in situations of exchange, and many cases concern real property acquired in a common law state, it is unclear whether the forced transmutation happens upon a simple change of domicile, or whether an exchange is required.⁹² The case law suggests that some of the common law states in question intend the forced transmutation to be imposed automatically upon the change of domicile, regardless of whether or not the community property has been exchanged for other property.⁹³ But at least upon exchange, and probably upon a simple change of domicile to some of these common law states, couples are forced to transmute their community property to some form of common law ownership, destroying the community nature of their property.⁹⁴

Two solutions are usually employed by common law states to deal with spouses' vested interests in former community property which has undergone a forced transmutation. Sometimes, if the community property was exchanged for new property and title to the new property was taken jointly, the common law state forces the couple to take the new property in some form of common law ownership.⁹⁵ For instance, in *Rozan v. Rozan*, a California couple bought North Dakota land with community property.⁹⁶ The Supreme Court of California found that the North Dakota real estate was thus community property,⁹⁷ but recognized that it could not affect title to land in another jurisdiction.⁹⁸ Despite this ruling, the North Dakota Supreme Court held,

[The] use of community funds did not impart the status or character of community property, with all its varied and unique incidents, to the so acquired North Dakota lands. Upon acquisition, using community property funds, each party in this instance acquired a separate yet undivided one-half ownership interest in the North Dakota real property . . .⁹⁹

Thus, North Dakota will require that property acquired with community property in that state be taken as separate property, destroying the community

⁹¹ See, e.g., *Tomaier v. Tomaier*, 23 Cal.2d 754, 759 (Cal. 1944) (“[Community] property rights are not lost simply because property is transported into another state and exchanged there for other property.”)

⁹² See, e.g., *Quintana*, 1985 So.2d at 580; *Stone*, 63 So.2d at 308-09; *Depas*, 1848 WL 4002 at *4; In re *Hunter's Estate*, 236 P.2d at 95 (in dicta); *Rozan*, 129 N.W.2d at 707; *Edwards*, 233 P. at 485; 40 Md. Atty. Gen. Op. 526 (1955).

⁹³ See, e.g., *Quintana*, 1985 So.2d at 580; *Stone*, 63 So.2d at 308-09; *Depas*, 1848 WL 4002 at *4; In re *Hunter's Estate*, 236 P.2d at 95 (in dicta); *Rozan*, 129 N.W.2d at 707; *Edwards*, 233 P. at 485; 40 Md. Atty. Gen. Op. 526 (1955).

⁹⁴ See, e.g., *Quintana*, 1985 So.2d at 580; *Stone*, 63 So.2d at 308-09; *Depas*, 1848 WL 4002 at *4; In re *Hunter's Estate*, 236 P.2d at 95 (in dicta); *Rozan*, 129 N.W.2d at 707; *Edwards*, 233 P. at 485; 40 Md. Atty. Gen. Op. 526 (1955).

⁹⁵ *Rozan*, 129 N.W.2d at 707.

⁹⁶ *Rozan v. Rozan*, 49 Cal.2d 322, 327 (1957).

⁹⁷ *Id.* at 327.

⁹⁸ *Id.* at 330.

⁹⁹ *Rozan*, 129 N.W.2d at 707.

nature of the property.¹⁰⁰ No other states could be found that have addressed this issue, but this seems to be the outcome that other common law states would reach as well.

Under the second approach, community property is exchanged for new property and title to the property is taken in the name of one spouse alone. In a community property state, such property would still often be considered community property.¹⁰¹ But in many common law states, taking title in such a fashion vests the full interest in the named spouse (often the husband).¹⁰² Because the community property exchanged for such solely-titled property belonged half to the other spouse (often the wife), many common law states will create a resulting trust in favor of this spouse to protect her half interest in the newly acquired property.¹⁰³ This result, as above, forces the couple to transmute community property to a common law form of joint ownership, destroying the community nature of the property.

If a state forces a couple to change ownership from community property to some form of joint ownership or to a resulting trust, the loss of the community nature of the property almost certainly destroys the ability to take advantage of the full step up. Leading commentators have come to this same conclusion.¹⁰⁴ And, more importantly, both a Ninth Circuit case and a Revenue Ruling support the denial of the application of § 1014(b)(6) in such cases.¹⁰⁵

In *Murphy v. Commissioner*, a California couple converted some real estate from community property to tenancy in common.¹⁰⁶ First the Service and then the court denied the application of § 1014(b)(6), holding that the provision does not apply to property that was held as community property in the past.¹⁰⁷ The key issue in *Murphy* was the character of the property under state law at the time of death.¹⁰⁸ Though this case did not deal with a move between states, it is analogous in that it deals with property formerly held as community property but now held in a form of separate joint ownership.¹⁰⁹ Thus, *Murphy*

¹⁰⁰ *Id.*

¹⁰¹ *See, e.g.,* *Tomaier v. Tomaier*, 23 Cal.2d 754, 759 (Cal. 1944).

¹⁰² *See, e.g., In re Hunter's Estate*, 236 P.2d 94, 99 (Mont. 1951).

¹⁰³ *See, e.g., Quintana v. Ordonez*, 1985 So.2d 577, 580 (Fla. Dist. Ct. App. 1967); *Stone v. Sample*, 63 So.2d 307, 308-09 (Miss. 1953); *Depas v. Mayo*, 1848 WL 4002 at *4 (Mo. 1848); *Edwards v. Edwards*, 233 P. 477, 485; *In re Hunter's Estate*, 236 P.2d at 95 (in dicta); 40 Md. Atty. Gen. Op. 526 (1955). *But see In re Hunter's Estate*, 236 P.2d at 99 (Supreme Court of Montana, misinterpreting California law, found that the wife had no vested interest in the community property used to purchase Montana real estate, and thus refused to impose a resulting trust.); *Commonwealth v. Terjen*, 90 S.E.2d 801, 804-05 (Va. 1956) (Virginia Supreme Court of Appeals wrongly relied on *In re Hunter* for an analysis of California law and came to the same conclusion as to wife's vested interest). *See also* FLA. STAT. ANN. §§ 732.216 - 732.228 (West 2003); MONT. CODE ANN. §§ 72-9-101 - 72-9-120 (1993) (Florida and Montana have since adopted the Uniform Act, perhaps changing their position on the issue of forced conversion of ownership forms).

¹⁰⁴ WILLIAM A. REPPY, JR. & CYNTHIA A. SAMUEL, *COMMUNITY PROPERTY IN THE UNITED STATES* 600-01 (6th ed. 2004).

¹⁰⁵ *Murphy v. Comm'r*, 342 F. 2d 356, 359 (9th Cir. 1965); Rev. Rul. 68-80, 1968-1 C.B. 348.

¹⁰⁶ *Murphy*, 342 F. 2d at 358.

¹⁰⁷ *Id.* at 359.

¹⁰⁸ *Id.* at 358-59.

¹⁰⁹ *Id.* at 358.

strongly suggests that in cases where parties move to states which force such changes in form of ownership, courts will not allow the full step up in basis.

The IRS takes this position, as well.¹¹⁰ Revenue Ruling 68-80 concerned a couple that moved from New Mexico, a community property state, to Virginia, a common law state.¹¹¹ The couple exchanged community property for a piece of Virginia real estate, taking title as tenants in common.¹¹² The Service said that in such situations, the surviving spouse cannot take the full step up since "there is nothing in the Internal Revenue Code or regulations that would indicate that section 1014(b)(6) of the Code relating to 'community property held' was intended to include separate property that had previously been converted from community property to separate property."¹¹³ Though this situation did not involve a forced transmutation, the facts are so analogous that it seems clear that the Service will take the same position. Revenue Ruling 68-80 strongly suggests that the IRS will not allow application of § 1014(b)(6) to property which has been converted from community property to separate joint ownership upon a move from a community property to a common law state.¹¹⁴

Furthermore, the conclusions reached by *Murphy*, Revenue Ruling 68-80, and the major commentators cited above all comport with the reasoning discussed under commingling, universal community agreements and the Uniform Act. The plain language of § 1014(b)(6) says that community property is property which is community property "under the community property laws of any State."¹¹⁵ In cases where a move has forced a switch to common law ownership forms, the property has ceased to be community property under the laws of the state. Under a plain language interpretation, it is quite reasonable that the IRS should deny the application of § 1014(b)(6). It would seem consistent for the Service to allow application of § 1014(b)(6) to commingling and universal community agreements, as well as (perhaps) to agreements under the Uniform Act, but not to changes of common law ownership forms upon moves to common law states.

While the approach may be consistent, the result is unfair. The community property system should be respected by common law states not only to protect migrating couples' full step up interests, but also to preserve their other community property interests as well. While it may seem fair for the Service to deny the full step up in cases where couples have voluntarily chosen to separate their property, it seems less fair to deny it in cases where couples were forced to change ownership form simply because they moved to a common law state and exchanged community property there. Nonetheless, the Service would be acting well within the plain meaning of § 1014(b)(6) if it were to deny application of the provision in such cases. The resolution of the issue probably lies with these states that force ownership form changes.

There are a number of prophylactic measures that migrating couples can employ to possibly preserve the character of community property upon a move

¹¹⁰ Rev. Rul. 68-80, 1968-1 C.B. 348.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ I.R.C. § 1014(b)(6) (2001).

to a common law state that forces a change in ownership form. William A. Reppy, Jr. and Cynthia A. Samuel suggest executing an agreement stating that no change of ownership form will occur upon moving to the common law state, assuming such an agreement would be valid in the new state.¹¹⁶ Such an agreement's "success would be enhanced if the stock certificates [or other moveable community property] were physically retained in the former community domicile."¹¹⁷ According to Gerald B. Treacy, Jr., one could also try "funding a revocable inter vivos trust with community property and selecting the law of the community property state as governing law."¹¹⁸ W. Peter Burns also recommends identifying community property as such in both spouses' wills.¹¹⁹ While the success of these methods is uncertain, it is possible that they could operate to save the full step up for couples moving to a common law state requiring a change in form of ownership of community property.

2. Common Law States That Preserve the Character of Community Property

Some states do recognize community property, at least upon exchanges, if not otherwise.¹²⁰ Common law states that preserve the character of community property probably also save the full step up for couples who move to these states with community property.¹²¹ In short, because community property is considered community property in these common law states, § 1014(b)(6) likely applies.

In the leading case of *People ex. rel. Dunbar v. Bejarano*, the Supreme Court of Colorado held that community property retained its character as such even though brought into Colorado, a common law state: "[We] are of the opinion that the rights incident to this form of ownership are so plain that they are entitled to recognition."¹²² Virginia's highest court came to the same conclusion in *Commonwealth v. Terjen*.¹²³ The Supreme Court of Ohio also agreed that community property brought into Ohio would remain community property.¹²⁴ Additionally, Missouri appears to have come to the same conclusion.¹²⁵ These cases do not involve exchanges, but do indicate, in opposition to

¹¹⁶ REPPY & SAMUEL, *supra* note 104, at 21-25.

¹¹⁷ *Id.*

¹¹⁸ Treacy, *supra* note 46, at 29.

¹¹⁹ Burns, *supra* note 46, at 333.

¹²⁰ See, e.g., *People ex. rel. Dunbar v. Bejarano*, 358 P.2d 866 (Colo. 1961) (Colorado); *Commonwealth v. Terjen*, 90 S.E.2d 801 (Va. 1956) (Virginia); *In re Kessler's Estate*, 203 N.E.2d 221 (Ohio 1964) (Ohio). See also *In re Estate of Perry*, 480 S.W.2d 893 (Mo. 1972) (Missouri) and note 63 *supra* (listing states having adopted the Uniform Community Property rights at Death Act).

¹²¹ I.R.C. § 1014(b)(6).

¹²² 358 p.2d at 868-69.

¹²³ 90 S.E.2d at 802-03.

¹²⁴ *In re Kessler's Estate*, 203 N.E.2d at 222-23.

¹²⁵ *In re Estate of Perry*, 480 S.W.2d 893 (Mo. 1972). An old leading case in the state, *Depas v. Mayo*, said that community property exchanged for Missouri real estate taken in the husband's name became the separate property of the husband, with a resulting trust in favor of the wife. 1848 WL 4002 at *4 (Mo. 1848). But in *In re Estate of Perry*, the Supreme Court of Missouri considered personal community property of a Texas couple left on a Missouri ranch. The court held, "Without any doubt, Texas community property laws of the

the cases in the preceding subsection, a willingness by these states' courts to recognize and preserve community property when brought into these states. In addition, as discussed in the preceding section, many states have adopted the Uniform Disposition of Community Property Rights at Death Act (Uniform Act), which may also preserve the character of community property in the adopting states.¹²⁶

Colorado and Virginia are among the states that have adopted the Uniform Act and the decisions discussed above were decided before these adoptions. It is not clear how their adoptions of the Uniform Act will impact the holdings in these two cases, but it probably will not affect them much. These cases hold that community property brought into the states remains community property,¹²⁷ presumably both during life and through death. The Uniform Act does not affect property during life and only states that that which was community property under another state's law will be disposed of as such in the adopting state.¹²⁸ The Uniform Act does not force community property to be transmuted to common law ownership and then subsequently disposed of as community property at death. It is designed to deal with property that had to be transmuted but ought to be disposed of as community property at death. Since Colorado and Virginia apparently preserve the character of community property anyway, the Uniform Act probably adds nothing to the character of imported community property for purposes of § 1014(b)(6).

The IRS has not spoken on the issue of how community property preserved as such in common law states will be treated under § 1014(b)(6), but two factors may suggest that it will allow the full step up. First, by the plain language of § 1014(b)(6), it would seem that the Service would have to allow the full step up in these situations. Community property is considered to be community property under the laws of these states.¹²⁹ As seen in the previous sections, the IRS tends to allow application of § 1014(b)(6) when property is considered community property under state law.

Second, as discussed in the Uniform Act section, the Oregon FSA suggests that the IRS will allow the full step up upon a move to a state that preserves the character of community property.¹³⁰ That FSA, one will recall, concerned a couple who moved from California to Oregon and exchanged community property for a piece of Oregon real estate.¹³¹ Because the property was considered community property under Oregon's version of the Uniform Act, the IRS stated that § 1014(b)(6) should apply.¹³² Though the Oregon FSA

nonresident appellant and her deceased spouse . . . control her property rights in the personal property having a situs in this state at the time of his death . . . [The presumption has not been rebutted that] all of the property was and is community property." In re *Estate of Perry*, 480 S.W.2d at 894-95, 896. Though this case did not involve a change of domicile to the common law state in question, it suggests that Missouri may recognize community property when brought into the state by couples moving there.

¹²⁶ See *infra* §§ 1 and 3.

¹²⁷ *Dunbar*, 338 P.2d 866; *Commonwealth v. Terjen*, 90 S.E.2d 801 (Va. 1956).

¹²⁸ UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT § 3.

¹²⁹ *Dunbar*, 358 P.2d at 868-69.

¹³⁰ 1993 WL 1609164 (IRS FSA).

¹³¹ *Id.*

¹³² *Id.*

dealt with a version of the Uniform Act, the situation is analogous to those in which a couple moves to a common law state that preserves the character of their community property. In fact, the case for the full step up is stronger in these states because their courts explicitly state that community property remains community property, whereas the Uniform Act only instructs that former community property be treated like community property at death.¹³³ Thus, if the Service will allow the application of § 1014(b)(6) for property under the Uniform Act, it likely will allow it in cases where common law states have preserved the nature of community property brought into these states.

Though the IRS has not spoken directly on point, the plain language of § 1014(b)(6), the FSA discussed above, and the dispositions of these states' courts suggests that the IRS will allow the full step up for community property brought into these common law states by couples moving to them.

3. *Conclusion to Changes in Marital Domicile Issues*

The effect of a move from a community property state to a common law state depends on the law of the common law state. If the common law state has adopted the Uniform Act, the couple may get the full step up.¹³⁴ For states that require community property to be converted to a form of common law ownership upon exchange, § 1014(b)(6) probably will not apply. For states that preserve the character of community property brought into them, the IRS may allow the application of § 1014(b)(6). Again, these conclusions are not certain, but the evidence suggests them.

E. *Community Property with Right of Survivorship*

An interesting area of community property that has not been extensively explored is community property with right of survivorship (CPWROS). The IRS has yet to speak authoritatively on the subject, but it seems that CPWROS could receive the full step up in basis under § 1014(b)(6). Many commentators believe that this hybrid will receive the § 1014(b)(6) full step up in basis¹³⁵ though others strongly disagree.¹³⁶

Community property with right of survivorship is allowed in most community property states,¹³⁷ and is a hybrid of community property and joint

¹³³ *Dunbar*, 358 P.2d at 868-69; UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT §§ 1, 3.

¹³⁴ I.R.C. 1014(b)(6).

¹³⁵ See, e.g., Arthur W. Andrews, *Community Property with Right of Survivorship: Uneasy Lies the Head that Wears a Crown of Surviving Spouse for Federal Income Tax Basis Purposes*, 17 VA. TAX REV. 577 (1998), Robert B. Fleming, *The Top Ten Changes in the New Uniform Probate Code*, ARIZ. ATT'Y, Aug./Sept. 1994, at 35.

¹³⁶ Andrews, *supra* note 135; REPPY & SAMUEL, *supra* note 104 at 3-20, *quoted in* Andrews, *supra* note 135, at n.29. ("[I]t is not firmly settled that the Internal Revenue Service will treat this hybrid as community property to give a stepped up basis to a surviving spouse's half interest.")

¹³⁷ See ARIZ. REV. STAT. ANN. §§ 14-1201(28) (West 1995), 33-431 C. & D. (West Supp. 1996); IDAHO CODE § 15-6-201 (Michie 1979); NEV. REV. STAT. ANN. 111.064.2. (Michie 1993); N.M. STAT. ANN. §§ 40-3-8.B. (Michie 1994), 45-2-805.A. (Michie 1995); TEX. PROB. CODE ANN. § 451 (West Supp. 1997); WASH. REV. CODE ANN. § 64.28.040.(1) (West 1994).

tenancy with right of survivorship (JTWROS). Generally, the property is treated as standard community property during life, but at death it passes to the survivor outside of the will just as it would with JTWROS property.¹³⁸ Thus, the couple gets the burdens and benefits of community property ownership during life and then the property is transferred to the survivor "without incurring the costs of probate, while at the same time preserving the usual 'stepped up' [fair market value] date of death basis for the survivor's own one half interest."¹³⁹

The general belief that CPWROS will receive the full step up is based on Revenue Ruling 87-98.¹⁴⁰ This ruling, discussed under the commingling and universal community agreement sections, concerned a couple living in a community property state that took title to real property as JTWROS.¹⁴¹ Though the property was held as JTWROS, the Service ruled that it was community property under state law, because of a recitation in the couple's wills that the property was community property.¹⁴² Thus, the Service allowed the full step up.¹⁴³ However, one must also guess that the right of survivorship was not operable because the property had been found to be community property under state law and not JTWROS. Thus, the analogy between the JTWROS in this ruling and CPWROS generally may not hold water, because the property in question here was merely community property with no right of survivorship. The situation is unclear, at best, but based on this ruling, it may be reasonable to believe that the IRS will allow the application of § 1014(b)(6) for CPWROS.

Arthur W. Andrews, however, argues that CPWROS will probably not receive the benefit of the full step up because half of it will not be included in the decedent's estate as required by § 1014(b)(6).¹⁴⁴ There is no debate that CPWROS will be considered community property for purposes of § 1014(b)(6),¹⁴⁵ it is generally considered community property under state law.¹⁴⁶ However, section 1014(b)(6) does require that "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."¹⁴⁷ Andrews notes that there are only two sections under the federal estate tax that might cause the necessary inclusion.¹⁴⁸ If neither of these sections operate to include half of the CPWROS in the decedent's estate, then § 1014(b)(6) cannot apply.

¹³⁸ See, e.g., WASH. REV. CODE ANN. § 64.28.040.(1) (West 1994).

¹³⁹ Andrews, *supra* note 135, at 582 (stating the common view).

¹⁴⁰ *Id.* at 582-83.

¹⁴¹ Rev. Rul. 87-98, 1987-2 C.B. 206.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ Andrews, *supra* note 135, at 605-07.

¹⁴⁵ See, e.g., *id.* at 604 (quoting M. Phillips, Federal Tax Implications of The Wisconsin Marital Property Act (3d special ed.), TAX PRACT. NEWSLETTER (IRS Milwaukee District), Apr. 1988, at 1, reprinted in HOWARD S. ERLANGER, MARITAL PROPERTY, TAXATION, AND ESTATE PLANNING IN WISCONSIN A-3 (1991)).

¹⁴⁶ See, e.g., WASH. REV. CODE ANN. § 64.28.040(1) (West 1994).

¹⁴⁷ Andrews, *supra* note 135, at 584.

¹⁴⁸ *Id.* at 599.

The first section which might cause inclusion is § 2033.¹⁴⁹ It states, “the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death.”¹⁵⁰ But CPWROS, by its very nature, is designed so that the decedent has no interest at death, but rather, the property passes by operation of law to the surviving spouse. Thus, Andrews points out that § 2033 will not cause inclusion because “the decedent’s interest was extinguished at death and is not part of the probate estate.”¹⁵¹ Therefore, another provision of the federal estate tax must be found to cause inclusion of the CPWROS or § 1014(b)(6) cannot apply.

The only other possible provision that might cause inclusion is § 2040 which deals with joint interests. Subsection (b) of § 2040 addresses joint interests between husband and wife.¹⁵² It states that the gross estate shall include half of the couple’s sole joint interest in property held as “tenants by the entirety” or “joint tenants with right of survivorship.”¹⁵³ It does not state that it includes CPWROS. Andrews points out that the two terms in § 2040 utilize:

very specific and technical property law terminology which has an established meaning based upon the common law origins of these tenancies as embellished by state statutes. It is hard to escape the conclusion that the statute on its face is unambiguous as to its application. This is because, as the Supreme Court has stated, “[W]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.” Since community property has different historical roots and attributes . . . it seems clear that these tenancies do not encompass community property.¹⁵⁴

Thus, Andrews concludes that § 2040 will not cause inclusion of half of the CPWROS in the decedent’s estate.¹⁵⁵ As a result, he concludes that CPWROS cannot receive the full step up in basis, because it does not fulfill the inclusion requirement of § 1014(b)(6).

Andrews analyzes the two IRS documents that address CPWROS. The first is Revenue Ruling 87-98. Andrews argues that the Ruling should be disregarded because the Service specifically states that half of the JTWROS property (which was found to be community property) “was included in [decedent]’s estate for federal estate tax purposes.”¹⁵⁶ Andrews maintains that by making this assumption, without explanation, the IRS has avoided addressing the question of whether CWPROS will be included in the decedent’s estate and has added nothing to the CPWROS issue.¹⁵⁷

While there are few IRS documents on CPWROS, there is a Tax Practitioner Newsletter from the IRS District Director in Milwaukee that addresses

¹⁴⁹ I.R.C. § 2033 (2001).

¹⁵⁰ *Id.*

¹⁵¹ Andrews, *supra* note 135, at 599.

¹⁵² I.R.C. § 2040(b) (2001).

¹⁵³ *Id.* § 2040(b)(2).

¹⁵⁴ Andrews, *supra* note 135, at 588-89 (quoting *N.L.R.B. v. Amax Coal Co.*, 453 U.S. 322, 329 (1981)).

¹⁵⁵ *Id.* at 599.

¹⁵⁶ *Id.* at 600 (quoting Rev. Rul. 87-98, 1987-2 C.B. 206).

¹⁵⁷ *Id.* at 602.

the issue.¹⁵⁸ This document deals with “survivorship marital property,” the Wisconsin equivalent of CPWROS.¹⁵⁹ In the newsletter, the District Director wrote, “based upon advice received from the National Office, survivorship marital property will definitely be considered community property for federal income tax basis purposes. This means, upon the death of the first spouse, a full step up in basis will be received under I.R.C. section 1014.”¹⁶⁰ Though this statement seems clear cut, it does not, Andrews points out, address whether CPWROS will be included in the gross estate; it simply seems to assume it.¹⁶¹ Thus, as with Revenue Ruling 87-98, this document adds little to the analysis of the CPWROS situation.

However, Andrews’s analysis of CPWROS inclusion hinges on an exceedingly technical reading of § 2040 that may not be applied in practice. Section 2040(b)(2)(B) includes property held as “joint tenants with right of survivorship” in the gross estate. While Andrews correctly argues that this term is a “very specific and technical property law [term] which has an established meaning,”¹⁶² it seems unlikely that the IRS would give such a technical reading of the statute since the language could easily cover CPWROS. Thus, the Service may very well conclude that § 2040(b)(2)(B) causes inclusion of CPWROS, which would allow the full step up.

This view is buttressed by the Tax Practitioner Newsletter from the IRS District Director in Milwaukee, discussed above.¹⁶³ There, again, the District Director wrote, “based upon advice received from the National Office, survivorship marital property will definitely be considered community property for federal income tax basis purposes. This means, upon the death of the first spouse, a full step up in basis will be received under I.R.C. section 1014.”¹⁶⁴ Andrews notes that this document assumes inclusion of CPWROS without any analysis of how this could occur.¹⁶⁵ But it is not unreasonable to think that the Service did, in fact, decide without noting it that CPWROS was includible under § 2040(b)(2)(B) and entitled to the full step up. In any case, based on the Tax Practitioner Newsletter the IRS seems to be willing to include CPWROS in the gross estate and, thereby, to allow the full step up.

Presently, it is unclear what the IRS response to CPWROS will be for purposes of § 1014(b)(6). Andrews’ analysis of the inclusion issue is not unreasonable. However, the two IRS documents discussed indicate a rather forgiving IRS attitude on the subject. This may be, as Andrews notes, simply because the Service has not thought about the inclusion issue.¹⁶⁶ On the other hand, it may be because the Service intends to apply § 2040(b)(2)(B) to include CPWROS in the decedent’s estate, allowing the full step up in basis.

¹⁵⁸ *Id.* at 604.

¹⁵⁹ *Id.* at 603-04.

¹⁶⁰ *Id.* at 604 (quoting M. Phillips, *supra* note 145, at 1, reprinted in ERLANGER, *supra* note 145, at A-3).

¹⁶¹ *Id.*

¹⁶² *Id.* at 588.

¹⁶³ *Id.* at 604.

¹⁶⁴ *Id.* at 604 (quoting M. Phillips, *supra* note 145, at 1, reprinted in ERLANGER, *supra* note 145, at A-3).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 601-05.

F. *The Alaska Community Property Act's Elective Regime*

In 1998, Alaska passed the Alaska Community Property Act, which created an elective community property regime in the state.¹⁶⁷ The Alaska regime functions like any other community property regime except that residents must choose to opt-in to the system, if they want it to apply, and they must choose which of their property will be held as community property.¹⁶⁸ Because of the regime's elective nature, a debate has raged ever since its adoption as to whether Alaska community property will be considered community property for purposes of § 1014(b)(6).¹⁶⁹ The evidence is unclear, as is the Service's position, but it is an essential question, since it concerns the fate of an entire state's community property regime for purposes of § 1014(b)(6).

Because Alaska's community property laws are derived from the Uniform Marital Property Act and are similar to Wisconsin's IRS-approved community property regime, some believe that Alaska community property will be community property for purposes of § 1014(b)(6).¹⁷⁰ But the Alaska Community Property Act contains one major difference from Wisconsin's laws: the Alaska act only applies if resident couples opt-in to the system.¹⁷¹ The imposition of the regime is not automatic; rather, taxpayers must proactively choose to live in community.¹⁷² The elective nature of the regime calls into question whether the Service will allow the full step up for Alaska community property.

This doubt arises from Oklahoma's experiment with elective community property in the 1940s and the subsequent United States Supreme Court case of *Harmon*, in which the Court found that elective community property was not community property for purposes of the federal income tax.¹⁷³ *Harmon* concerned an Oklahoma couple who had elected to apply Oklahoma's community property regime to themselves in order to split their income for federal tax purposes (which lowered their income tax burden as to ordinary income under the applicable law).¹⁷⁴

The question in *Harmon* was whether such an elective regime was more like a typical community property regime, which validly splits income,¹⁷⁵ or more like the fact pattern in *Lucas v. Earl*, the classic federal income tax case in which the taxpayers' income split was disallowed.¹⁷⁶ In *Lucas v. Earl*, the husband had assigned half of his income to his wife, after which the couple tried to split the income for federal income tax reporting.¹⁷⁷ As the Court wrote in *Harmon*, "Under *Lucas v. Earl* an assignment of income to be earned or to accrue in the future, even though authorized by state law . . . , is ineffective to render the income immune from taxation as that of the assignor."¹⁷⁸

¹⁶⁷ Alaska Community Property Act, ALASKA STAT. § 34.77.010-.995 (Michie 1998).

¹⁶⁸ Alaska Community Property Act § 34.77.030.

¹⁶⁹ See, e.g., Shaftel & Greer, *supra* note 47; Blattmachr, et al., *supra* note 68.

¹⁷⁰ See, e.g., Blattmachr, et al., *supra* note 68, at 624.

¹⁷¹ Alaska Community Property Act § 34.77.030.

¹⁷² *Id.*

¹⁷³ *Comm'r v. Harmon*, 323 U.S. 44, 48-49 (1944).

¹⁷⁴ *Id.* at 45.

¹⁷⁵ See, e.g., *Poe v. Seaborn*, 282 U.S. 101 (1930).

¹⁷⁶ *Harmon*, 323 U.S. at 45-46.

¹⁷⁷ *Lucas v. Earl*, 281 U.S. 111, 113-14 (1930).

¹⁷⁸ *Harmon*, 323 U.S. at 46.

In *Harmon*, the Court found Oklahoma's elective regime to be more like *Lucas v. Earl*, and thus it was not a valid community property system for purposes of the federal income tax.¹⁷⁹ "Communities are of two sorts," the Court wrote, "consensual and legal. A consensual community arises out of contract [as in *Lucas v. Earl*]," whereas a legal community is created automatically under state law upon marriage.¹⁸⁰ The Court even stated,

[We] assume that, once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in [basically] any community property State . . . The important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony.¹⁸¹

The automatic nature of traditional community property regimes is the key to their validity for federal income tax purposes, concerning the splitting of income. Thus, it would seem that any elective community property regime runs afoul of *Harmon* and will be declared invalid for federal income tax purposes, including § 1014(b)(6).

Though the IRS has not spoken on the validity of the Alaskan regime or the applicability of *Harmon*, there are numerous arguments against a reading of *Harmon* that holds elective community property regimes must always fail for purposes of § 1014(b)(6).¹⁸²

First, according to Blattmachr, et al., *Harmon* was decided before the passage of § 1014(b)(6), but only by a scant four years, and yet the legislative history of this section makes no mention of a differentiation between opt-in (elective) and opt-out (traditional) community property regimes.¹⁸³ Arguably, if Congress intended § 1014(b)(6) to apply to only one type of community property regime it would have said so in the wake of *Harmon*.

Second, section 1014(b)(6) explicitly applies to that which is community property "under the community property laws of . . . any foreign country . . .," probably including the German system, which seems to require election.¹⁸⁴ Indeed, a footnote in a 1986 Tax Court case states, "Petitioner [taxpayer] . . . originally argued that he and his wife had elected an optional marital regime knows [sic] as *gutergemeinschaft*, which respondent[, the IRS,] concedes is a community property regime."¹⁸⁵ In this case, the taxpayer, a German nonresident alien, had reported only half of his income to the IRS, since he argued that the other half inured directly to his wife under Germany's elective community property regime.¹⁸⁶ The IRS, in a seeming disavowal of *Harmon*, at first conceded that this elective regime was indeed a community property regime, but ultimately the argument was moot because the taxpayer conceded that he and his spouse had never actually elected community property treatment.¹⁸⁷ Commentators Shaftel and Greer point out that it is unclear whether *Harmon* was

¹⁷⁹ *Id.* at 47-49.

¹⁸⁰ *Id.* at 46.

¹⁸¹ *Id.* at 47-48 (emphasis added).

¹⁸² See, e.g., Shaftel & Greer, *supra* note 47; Blattmachr, et al., *supra* note 68.

¹⁸³ Blattmachr, et al., *supra* note 68, at 630.

¹⁸⁴ *Id.* at 630 n.66.

¹⁸⁵ *Angerhofer v. Comm'r*, 87 T.C. 814, 816 n.4 (1986).

¹⁸⁶ *Id.* at 816.

¹⁸⁷ *Id.*

addressed in this concession,¹⁸⁸ but the concession implies that *Harmon* may not apply to Alaska's elective regime.

Third, Justice Douglas makes a convincing argument in his dissent in *Harmon* that there is a strong consensual nature to traditional community property regimes, as well.¹⁸⁹ Douglas asks, is not marriage itself a contract that the spouses choose to enter into, just as the taxpayers entered into an assignment of income contract in *Lucas v. Earl*?¹⁹⁰ Is not a move to a community property state, which thus creates community property in the future, a consensual act by the spouses?¹⁹¹ Indeed, cannot spouses, upon such a move, even consensually transmuted their separate property to community property by a universal community agreement?¹⁹² Citing Douglas' dissent on this final point, Shaftel and Greer write, "It seems unfair for the Internal Revenue Service to acquiesce in this 'consensual' characteristic of existing community property states, yet deny it to elective community property systems."¹⁹³ Other commentators have agreed with this sentiment.¹⁹⁴ In light of these arguments, the case for extending *Harmon* to invalidate Alaska's community property regime seems weak at best.

Instead, most commentators believe that *Harmon* should be limited to the facts of the case – assignment of income situations, not the validity of elective community property regimes for purposes of § 1014(b)(6).¹⁹⁵ As Shaftel and Greer note, "this may well be the Service's position."¹⁹⁶ They then go on to cite Revenue Ruling 77-359, discussed *supra*, in which the Service ruled that a universal community agreement effectively transmuted separate property to community property.¹⁹⁷ But at the end of the ruling, the Service adds this telling cautionary note: "To the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns."¹⁹⁸ Thus, Shaftel and Greer note, the Service is perhaps limiting *Harmon* to the assignment of income context.¹⁹⁹ Most commentators believe that this should be the result and that Alaska community property should receive the benefit of the full step up in basis.²⁰⁰

Needless to say, the applicability of *Harmon* to Alaska community property is far from clear. *Harmon* may stand for the proposition that any community property produced by an elective regime will not be considered community

¹⁸⁸ Shaftel & Greer, *supra* note 47, at 25 n.89.

¹⁸⁹ *Harmon*, 323 U.S. at 50-57.

¹⁹⁰ *Id.* at 53.

¹⁹¹ *Id.*

¹⁹² *Id.* at 54.

¹⁹³ Shaftel & Greer, *supra* note 47, at 13.

¹⁹⁴ Blattmachr, et al., *supra* note 68, at 629.

¹⁹⁵ *Id.*; Shaftel & Greer, *supra* note 47, at 13-14.

¹⁹⁶ Shaftel & Greer, *supra* note 47, at 13.

¹⁹⁷ *Id.*; Rev. Rul. 77-359, 1977-2 C.B. 24.

¹⁹⁸ Rev. Rul. 77-359, 1977-2 C.B. 24; as stated in *supra* note 49, this ruling flies in the face of basic community property law. For instance, IDAHO CODE § 32-906(1) (Michie 2004) states that income from separate property is community property (and thus can be split). The issue seems unresolved by the Service.

¹⁹⁹ Shaftel & Greer, *supra* note 47, at 13.

²⁰⁰ *Id.* at 14; Blattmachr, et al., *supra* note 68, at 629-30.

property for purposes of federal taxation, including § 1014(b)(6). Or *Harmon* may, as suggested by Revenue Ruling 77-359, be limited to the assignment of income context, meaning that for purposes of the full step up, elective community property will be considered community property. Or *Harmon* may be overruled at its first challenge by an Alaskan resident, due to the logical inconsistencies in its reasoning, as pointed out by Justice Douglas' dissent. Such a resident is sure to be supported by a vigorous amicus curiae brief by the state of Alaska. For now, however, the validity of Alaska's elective community property regime remains a mystery.

G. Community Property Trusts Created By Community Property State Residents

Another important area of community property that has long caused confusion is whether community property used by community property state residents to fund trusts remains community property for purposes of § 1014(b)(6). The answer is unequivocally yes, as long as such property remains community property under state law and half of its value is includible in the decedent's gross estate.²⁰¹

In Revenue Ruling 66-283, the IRS considered a revocable trust funded with community property by California residents.²⁰² The Service noted that community property held by a trustee retains its community character under California law (unless the grantors provide otherwise) and that the federal estate tax provisions caused inclusion of half the trust in the estate of the first spouse to die.²⁰³ Thus, the Service ruled that the trust property was community property and received the full step up under § 1014(b)(6).²⁰⁴ This, of course, fits within the plain language of § 1014(b)(6), which requires that the community property be community property under state law and that half of the property be included in the estate of the first spouse to die.

Whether state law considers community property used to fund a trust to be community property is another question, however. In Alaska, California, Texas, and Wisconsin, community property transferred into a trust remains community property either automatically or by the couple's provision of such in the trust instrument.²⁰⁵ While no clear authority exists for the other community property states, one commentator points out, "Because the character of community property is generally not affected by how title is held . . . , it would follow that titling property in the name of a revocable trust or trusts should not affect the community property character of the property."²⁰⁶ In any case, Revenue Ruling 66-283 indicates that trust property will be considered community property as long as it is found to be community property under state law. Thus,

²⁰¹ Rev. Rul. 66-283, 1966-2 C.B. 297.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ Alaska Community Property Act § 34.77.060(b); CAL. FAM. CODE § 761 (West 1994); WIS. STAT. § 766.31(5) (2001); *Jameson v. Bain*, 693 S.W.2d 676, 681 (Tex. App. 1985).

²⁰⁶ Shelly D. Merritt, *Planning for Community Property in Colorado*, COLO. LAW., June 2002, at 79, 82.

depending on state law, community property in a trust can take advantage of § 1014(b)(6).

H. Alaska Community Property Trusts

A final area for consideration is whether property transferred into an Alaska community property trust by nonresidents will be considered community property for purposes of § 1014(b)(6). Though it might seem that such trusts could not take advantage of § 1014(b)(6), there are some arguments in favor of allowing the full step up.

As part of the Alaska Community Property Act, Alaska's legislature passed a statute allowing for the creation of Alaska community property trusts, which can be created by nonresidents.²⁰⁷ The nonresident couple need only comply with a few requirements, such as having an Alaskan trustee, and they have then transmuted the trust funds to community property.²⁰⁸ It is unclear, however, whether the IRS will apply § 1014(b)(6) to such property.

Community property created by Alaska community property trusts might seem to be an abuse of the full step up, but many commentators are quite certain they will be effective for purposes of § 1014(b)(6).²⁰⁹ The IRS has not spoken on Alaska community property trusts, but a couple of arguments weigh in favor of their validity for § 1014(b)(6) purposes.

First, under standard trusts law, the grantor of the trust can usually choose the law that will govern the trust (here it would be Alaska law).²¹⁰ Moreover, as Shaftel & Greer point out, the *Restatement (Second) Conflict of Laws* would probably apply Alaska law to such trusts.²¹¹ Section 6 of the *Restatement* gives seven factors to consider when deciding which law to apply and one of the most important in the context of trusts is the expectation of the parties.²¹² In Alaska community property trusts, the expectation of the parties would, of course, call for the application of Alaska law. As a result, nonresident grantors of Alaska community property trusts might be able to validly choose Alaska law to govern their trusts, meaning that the trust property would be community property. Thus, such trust property would fall within the plain language of § 1014(b)(6), which requires that property be community property "under the community property laws of any State . . ."

The Tax Court holding in *Richman v. Commissioner* supports the grantor's right to choose the governing law. In *Richman*, a Texas resident had an interest in a Massachusetts trust that called for Massachusetts law to govern.²¹³ Upon his death, his estate argued that Massachusetts law applied and that the

²⁰⁷ Alaska Community Property Act § 34.77.060(b).

²⁰⁸ *Id.* §§ 34.77.060(b) & 34.77.100.

²⁰⁹ Blattmachr, et al., *supra* note 68, at 631; Shaftel & Greer, *supra* note 47, at 16-17.

²¹⁰ Blattmachr, et al., *supra* note 68, at 636-37 nn.90-91 (citing 5A SCOTT, ON TRUSTS §§ 598, 611 (W. Frachter 4th ed. 1989) and RESTATEMENT (SECOND) CONFLICT OF LAWS § 276 (1971)); Shaftel & Greer, *supra* note 47, at 16-17 (citing RESTATEMENT (SECOND) CONFLICT OF LAWS, *supra*, at §§ 6, 187, 258, 270).

²¹¹ Shaftel & Greer, *supra* note 47, at 16-18.

²¹² RESTATEMENT (SECOND) CONFLICT OF LAWS, *supra* note 210, at § 6(2) (1971) & cmt. g on Subsection (2).

²¹³ *Richman v. Comm'r*, No. 22935-91, 1994 WL 456332 at *1-2 (U.S. Tax Ct. Aug. 23, 1994).

interest was JTWROS, meaning it would qualify for a marital deduction under § 2056 of the federal estate tax.²¹⁴ The IRS argued that Texas law had to apply, meaning the interest would be community property and would pass through his will, making the trust property ineligible for the marital deduction at that time.²¹⁵ The court applied Texas choice of law rules, which called for a “most-significant-relationship” test under the *Restatement (Second) Conflict of Laws*, unless the parties had made a valid choice of law in the trust instrument.²¹⁶ The court held that the parties had validly chosen Massachusetts law in the trust instrument.²¹⁷ The court went on to refute the Service’s claim that this choice should not be respected because, under the *Restatement*, Massachusetts had no “sufficient relationship” with the trust.²¹⁸ To the contrary, the court found that Massachusetts had a very significant relationship with the trust, noting, among other things, that both trustees were in Massachusetts.²¹⁹ The court thus applied Massachusetts law and allowed the deduction.²²⁰

The facts in *Richman* are quite analogous to the situation of nonresidents of Alaska attempting to choose Alaska law to govern their Alaska community property trust. They would presumably choose Alaska law to govern the trust and would, as required by statute, have a trustee who resided in Alaska.²²¹ Further, their expectations would clearly weigh in favor of applying Alaska law. Thus, if the couple’s domiciliary state had choice of law rules similar to those of Texas, *Richman* would require that Alaska law apply. The trust property would then be community property “under the community property laws of any State . . . ,”²²² satisfying the plain meaning of § 1014(b)(6) and allowing the full step up.

A final argument in favor of allowing nonresidents to use Alaska community property trusts for § 1014(b)(6) purposes lies in the very intent of § 1014(b)(6) itself. As discussed in the introduction, the purpose of § 1014(b)(6) was “to equalize the incidence of taxation between community-property and common-law states, not to provide a special benefit to community-property taxpayers.”²²³ Since § 1014(b)(6) is no longer so needed as an equalizer, it primarily serves as a tax loophole for residents of community property states, while common law state residents are excluded from the full step up benefits. Thus, it makes sense to allow common law state residents who are willing to submit to Alaska trust law to take advantage of § 1014(b)(6), lest there continue to be “a special benefit [for] community-property taxpayers.”²²⁴

Though Alaska community property trusts seem, on their face, to abuse § 1014(b)(6), there are arguments in favor of allowing them for purposes of the full step up. But this area of the law is completely untested, and the IRS posi-

²¹⁴ *Id.* at *1.

²¹⁵ *Id.*

²¹⁶ *Id.* at *5.

²¹⁷ *Id.* at *7.

²¹⁸ *Id.* at *8.

²¹⁹ *Id.*

²²⁰ *Id.* at *10.

²²¹ Alaska Community Property Act §§ 34.77.060(b).

²²² I.R.C. § 1014(b)(6) (2001).

²²³ *Willging v. United States*, 474 F.2d 12, 14 (9th Cir. 1973).

²²⁴ *Id.*

tion is unknown. Thus, nonresidents should approach Alaska community property trusts with caution.

CONCLUSION: THE FUTURE OF § 1014(b)(6)

The IRS appears to be very forgiving in the application of § 1014(b)(6). The Service seems to have no problem allowing the full step up in cases of commingling, universal property agreements, application of the Uniform Act and community property trusts in certain states.²²⁵ And it will probably allow application of § 1014(b)(6) upon moves to certain common law states.²²⁶ It is unclear how the Service will treat CPWROS, elective community property in Alaska, and Alaska community property trusts,²²⁷ but future IRS action should clarify how it views such property for purposes of § 1014(b)(6). Indeed, the Service only tends to deny the full step up when property clearly fails to fit within the plain meaning of § 1014(b)(6).

Yet this forgiving stance is surprising because § 1014(b)(6) has long outlived its purpose as a taxation equalizer between community property and common law states. Now, due in part to this forgiving stance, it is primarily a tax loophole for community property state residents. So what future does this widely used provision have in the landscape of the Internal Revenue Code?

It is very possible that § 1014(b)(6) will disappear entirely in the near future, having outlived its original purpose. Under current law, all of § 1014 is set to disappear in 2010,²²⁸ but will reappear thereafter.²²⁹ Additionally, the Clinton Administration's Fiscal 2001 Budget Proposal recommended the permanent elimination of § 1014, explaining:

When enacted in 1948, the stepped-up basis for community property was premised on the fact that the usual case was that practically all the wealth of the married couple was the property of the husband. Societal changes and changes to the estate tax treatment of jointly held property in 1981 have undermined the premises on which section 1014(b)(6) was based. Consequently, surviving spouses in community property states now enjoy an unwarranted tax advantage over those in common law states.²³⁰

Though this proposal was never acted upon in a permanent manner, the death of section 1014(b)(6) looms as long as it provides community property state taxpayers with a major tax advantage over common law state taxpayers.

Although it may have outlived its original purpose, section 1014(b)(6) is still one of the most widely used tax loopholes in the Internal Revenue Code. And as long as it survives, the section will continue to present fascinating issues as the IRS defines its boundaries.

²²⁵ See *supra* sections A, B, C, and G.

²²⁶ See *supra* section D.

²²⁷ See *supra* sections E, F, and H.

²²⁸ I.R.C. § 1014(f) (2005).

²²⁹ Economic Growth and Tax Relief Reconciliation Act of 2001 § 901, I.R.C. § 1 (2005).

²³⁰ Clinton Administration's Fiscal 2001 Budget Proposal, *quoted in* Jerome Ostrov, *Estate Tax Issues Associated with Jointly Held Real Estate*, PLIREF-TAXREL § 13:4.5, 13-28 (2001) (internal citation omitted). Also cited as Dept. of Treas. Revenue Proposal of Feb. 1999, in Shaftel & Greer, *supra* note 47, at 23.