TAX MANAGEMENT PORTFOLIOS™

ESTATES, GIFTS, AND TRUSTS

Community Property: General Considerations

by

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PORTFOLIO DESCRIPTION

Bloomberg Tax Portfolio, *Community Property: General Considerations*, No. 802-3rd, discusses the origins, the general characteristics, and the federal income, gift, estate, and generation-skipping transfer tax aspects of community property. The 14 states in which some form of community property is in effect are: Alaska (elective), Arizona, California, Florida (elective), Idaho, Kentucky (elective), Louisiana, Nevada, New Mexico, South Dakota (elective), Tennessee (elective), Texas, Washington, and Wisconsin.

This Portfolio describes the general characteristics of community and separate property, as well as those of combined community and separate property. It also describes the application of the gift, estate, and generation-skipping transfer tax laws to community property, and the application of the income tax laws to community property in estate planning.

Community property is a form of co-ownership between spouses in which each spouse owns an undivided one-half interest in each item of community property onerously acquired during marriage, regardless of the manner in which the property is titled. Community property ownership exists between spouses, and all property acquired out of earnings during marriage is presumed to be community property. In addition, the proceeds of, and the income earned with respect to, community property are themselves treated as community property. In about half of the community property states, the income from a spouse's separate property is also treated as community property. All property acquired before marriage, after its termination, or by gift, devise, bequest, or inheritance is separate property. Gifts of community property can generally be made only with the consent of both spouses. In some community property states, spouses are free to establish their own rules as to the character of property already acquired or which will be acquired as community or separate property.

A gift of community property is generally treated as a gift by each spouse of a one-half interest in the property. Section 2033 generally requires inclusion in a decedent's gross estate of the value of all the decedent's separate property and the value of one-half of all of the community property. The estate tax consequences of owning various types of community property are discussed in detail, as is the deductibility of administrative expenses and losses.

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DETAILED ANALYSIS

I. Introduction

An estate planner practicing outside the community property states — Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin,[1] and more recently Alaska, Tennessee, South Dakota, and Kentucky, which have adopted an elective community property system — may be unaware of problems created when a client has lived or acquired property in a community property state, or is dealing with someone residing in a community property state. This Portfolio analyzes the special rules involved when all or part of the client's property consists of community property. Detailed treatment is given to those estate planning and probate problems that arise as consequences of owning community property.

A summary of state community property law precedes consideration of particular areas important to estate planners.

[1] Guam and Puerto Rico are community property territories. *See* IRM 25.15.5.2 (07-24-2017).

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II. Summary of Community Property Law

Community property law governs the interests of married persons in property acquired during marriage in a community property state. A knowledge of community property law is important even in common law property states, because community property retains its community character even if it is moved to a common law property jurisdiction.[2] Even when community property is exchanged for other property in a common law property state, the respective interests of the spouses are protected.[3] Community property law in the state of the spouses' residence also governs rights of creditors, so any dealings with married persons living in a community property state requires knowledge of that law. State community property law governs the rights of spouses in property for purposes of federal income, gift, estate, and generation-skipping transfer taxes.[4]

Although a number of community property rules have general applicability among the community property jurisdictions, considerable local variations exist. It is therefore particularly important when dealing with a community property question to ascertain the law of the controlling jurisdiction. The following summary highlights only the basic principles of the community property system. It is assumed, unless otherwise stated, that the parties are domiciled in, and all transactions take place in, a community property jurisdiction.

A. Origins of Community Property

Community property law in the United States is primarily of Spanish origin, although there remains some French influence in Louisiana.[5] Community property law originally seems to have developed from Germanic tribal practices introduced in Spain following the fall of the Roman Empire. Early emigrants to the Spanish possessions in the New World carried with them elements of the Spanish legal system.

In the United States, the Spanish system was retained in some of the territories acquired from Spain, Mexico, and France during the 1800s. Upon admission to statehood, several of the southwestern states adopted constitutional or statutory provisions continuing the community property system as practiced at that time. Other states, although having no substantial contact with Spanish culture or institutions, nevertheless adopted the community property system, due perhaps to their desire to attract women as settlers.[6] Wisconsin adopted a community property system after the Uniform Law Commission promulgated the Uniform Marital Property Act. The elective community property systems in Alaska, Tennessee, South Dakota, and Kentucky are recent enactments, intended to provide certain tax benefits that do not function as a comprehensive marital property regime as in the traditional community property states, so those elective systems are described separately in this section.

B. The Necessary Relationship

In order to characterize property as community property, there must be a valid and existing marital relationship or, in California, Washington and Nevada, a registered domestic partnership.[7] California expanded the registered domestic partnership option to all couples over the age of 18 in 2019.[8] Nevada has retained its registered domestic partnership statutes first enacted in 2009, and Washington has now limited registered domestic partnerships to couples where one member of the couple is over the age of 62.[9]

There can be no community property with a nonmarital cohabitation that is not a registered domestic partnership, as no valid relationship exists. Parties can have no true community interest in property acquired during the existence of an invalid marriage.[10] However, the courts generally protect the interests of the party or parties who entered into such a relationship in good faith, by applying either a putative marriage doctrine or through the application of general principles of partnership or joint venture.[11] Of course, these problems increase in complexity when the putative marriage is undertaken during the existence of another, legal marriage.[12] Common law marriages are

[2] *Doss v. Campbell*, 19 Ala. 590 (1851); *Rozan v. Rozan*, 49 Cal.2d 322, 317 P.2d 11 (1957); Restatement (Second) of Conflict of Laws §260 (1971).

[3] *Rozan v. Rozan*, 49 Cal.2d 322, 317 P.2d 11 (1957).

[4] *Poe v. Seaborn*, 282 U.S. 101 (1930) (Wash. law); *Massaglia v. Commissioner*, 286 F.2d 258 (10th Cir. 1961) (N.M. law); *Bishop v. Commissioner*, 152 F.2d 389 (9th Cir. 1945) (Cal. law).

[5] *See generally* William Q. de Funiak & Michael J. Vaughn, Principles of Community Property 15-91 (2d ed. 1971).

[6] *See generally* Marion R. Kirkwood, *Historical Background and Objectives of the Law of Community Property in the Pacific Coast States*, 11 Wash. L. Rev. 1 (1936).

[7] *See LaFrance v. Cline*, 477 P.3d 369 (Nev. 2020), where a same-sex couple entered a civil union in Vermont in 2000 but did not register the union in Nevada where they resided. Registering is required to trigger the statutory arrangement for community property. The couple entered into marriage in Canada in 2003. *Obergefell v. Hodges*, 576 U.S. 644 (2015) applies retroactively, requiring recognition of the parties' marriage in 2003, before Nevada's ban on same sex marriage was found unconstitutional in 2014.

[8] Cal. Fam. Code §297.

[9] Wash. Rev. Code §26.60.030.

[10] *Barr v. Commissioner*, 10 T.C. 1288 (1948) (Cal. law); *In re Marriage of Liu*, 197 Cal. App. 3d 143, 242 Cal. Rptr. 649 (1987) (no community property if marriage annulled); *In re Estate of Hafner*, 184 Cal. App. 3d 1371, 229 Cal. Rptr. 676, 682 n.12 (1986); *Garduno v. Garduno*, 760 S.W.2d 735 (Tex. App. 1988) (property acquired outside legally recognized marriage is jointly owned separate property, not community property). *But see Hammett v. Hammett*, 453 P.3d 1145 (Ariz. App. 2019) (citing Ariz. Rev. Stat. Ann. §25-211, court found that community property principles apply to property and debt even during a marriage that results in an annulment).

[11] *Ceja v. Rudolph & Sletten, Inc.*, 56 Cal.4th 1113, 158 Cal.Rptr.3d 21, 302 P.3d 211 (2013) (putative); *In re Marriage of Liu*, 197 Cal. App. 3d 143, 242 Cal. Rptr. 649 (1987); *Pack v. Vartanian*, 232 Cal. App. 2d 466, 42 Cal. Rptr. 729 (1965) (putative marriage); *Clark v. Clark*, 192 So.2d 594 (La. Ct. App. 1966); *Rupert v. Rupert*, 367 P.3d 815 (Nev. 2010) (putative); *Mathews v. Mathews*, 292 S.W.2d 662 (Tex. Civ. App. 1956) (putative marriage); *Soltero v. Wimer*, 159 Wash.2d 428, 150 P.3d 552 (2007); *West v. Knowles*, 50 Wash.2d 311, 311 P.2d 689 (1957); *Poole v. Schrichte*, 39 Wash.2d 558, 236 P.2d 1044 (1951) (partnership); *Thomas R. Andrews*, *Cohabitating with Property in Washington: Washington's Committed Intimate Relationship Doctrine*, 53 Gonz. L.Rev. 293 (2017–2018); Note, *In re Cary: A Judicial Recognition of Illicit Cohabitation*, 25 Hastings L. J. 1226 (1974); Comment, *Rights of the Putative and Meretricious Spouse in California*, 50 Cal. L. Rev. 866 (1962). *See generally* William Q. de Funiak & Michael J. Vaughn, Principles of Community Property 96–108 (2d ed. 1971).

[12] *E.g.*, *Spearman v. Spearman*, 482 F.2d 1203 (5th Cir. 1973) (Cal. law); *Tucker v. Joseph*, 292 So.2d 357 (La. Ct. App. 1974); *Jernigan v. Scott*, 518 S.W.2d 278 (Tex. Civ. App. 1974); cases cited in William Q. de Funiak & Michael J. Vaughn, Principles of Community Property, 99 (2d ed. 1971); *see* Casey Faucon, *Living Separate and Apart: Solving the Problem of Putative Community Property in Louisiana*, 85 Tul. L. Rev. 771 (2011). Bigamous marriages may produce community property. *See Price v. Price*, 326 So.2d 545 (La. Ct. App. 1976).

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not recognized in most community property states,[13] but a common law marriage established in a state that allows it is likely to be accepted as valid if the couple later moves to a community property state.[14]

In the wake of *Marvin v. Marvin*,[15] a number of courts have considered the property rights of the parties to nonmarital relationships.[16] In Washington, the court may divide what would have been community property if the couple had been married ("relationship property") between the cohabitants if they were in a "committed intimate relationship."[17] At the end of the relationship, either by death of one of the parties or the parties' separation, the court has the power to make an equitable division of the relationship property of the parties.[18]

In California and Washington, by statute, the accumulation of community property stops if the couple are living "separate and apart."[19] This determination is a subjective one based on the intentions of the parties, and in Washington, and both spouses must accept that the marriage is defunct.[20] Section 66 gives some relief from income tax liability on a spouse's income to separated spouses who do not have the advantage of a separate and apart statute.[21]

For a detailed discussion of marriage and common law marriage, see 858 T.M., *Family, Kinship, Descent, and Distribution.*

C. Characterization of Property as Community or Separate

In community property states, the term "community property" comprises, in general, property acquired by either spouse during marriage in some manner other than as donee of a gratuitous transfer.[22] Generally, community property includes the personal earnings of both spouses, such as wages, salary, and property acquired by the labor of either spouse. Property purchased with community property is also community property. Property acquired before marriage or acquired by either spouse during marriage by gift, devise, or descent is the separate property of the acquiring spouse. Community property is generally defined by statute in all community property states. For example, the statutory definition in Washington State is "property that is not within the definition of separate property and is acquired after marriage or after registration of a state registered domestic partnership by either domestic partner or either husband or wife or both."[23] In other words, community property is any property acquired while the couple is married that is not classified as separate property. Mere expectancies and other interests which do not constitute "property" cannot constitute community property.[24]

Property attributable to the personal efforts of either spouse during marriage is also community property.[25] The proceeds and income from community property are themselves community property.[26]

1. Community Property Presumption; Commingling of Separate and Community Property

There is a general presumption that property acquired during marriage or owned by a married person during marriage is community property, and the party asserting separate property characterization will have the burden to trace the asset to a separate property source.[27] The presumption is not generally overcome by the fact that record title to property is in the name of one spouse alone.[28]

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[13] William Q. de Funiak & Michael J. Vaughn, Principles of Community Property 95–96 (2d ed. 1971). Only Texas recognizes common law marriages. *See Ex parte Threet*, 160 Tex. 482, 333 S.W.2d 361 (1960), Tex. Fam. Code Ann. §2.401, §2.402. Idaho recognized common law marriage formed before January 1, 1996 (*In re Estate of Brock*, 94 Idaho 111, 482 P.2d 86 (1971), *citing Dire v. Dire-Blodgett*, 140 Idaho 777, 102 P.3d 1096 (2004)) and statutorily designated common law marriages formed after that date to be invalid. *See Wilkins v. Wilkins*, 137 Idaho 315, 48 P.3d 644 (2002); Idaho Code §32-201, §32-301.

[14] *In re Estate of Gallagher*, 35 Wn.2d 512, 515, 213 P.2d 621 (1950).

[15] 18 Cal.3d 660, 557 P.2d 106 (1976).

[16] *See, e.g., Dominguez v. Cruz*, 95 N.M. 1, 617 P.2d 1322 (Ct. App. 1980); *see also* Comment, *Marvin v. Marvin: Five Years Later*, 65 Marq. L. Rev. 389 (1982); Grace G. Blumberg, *Cohabitation Without Marriage: A Different Perspective*, 28 UCLA L. Rev. 1125 (1981).

[17] *Witt v. Young*, 168 Wash. App. 211, 275 P.3d 1218 (2012) (*quoting Connell v. Francisco*, 127 Wash.2d 339, 898 P.2d 831 (1995)); Thomas R. Andrews, *Cohabitating with Property in Washington: Washington's Committed Intimate Relationship Doctrine*, 53 Gonz. L.Rev. 293 (2017–2018).

[18] *Langeland v. Drown*, 195 Wash.App. 74, 380 P.3d 573 (2016).

[19] Wash. Rev. Code §26.16.140; Cal. Fam. Code §771.

[20] *Seizer v. Sessions*, 132 Wash.2d 642, 940 P.2d 261 (1997).

[21] *See* III.D., below.

[22] *See Tr. Servs. of Am., Inc. v. United States*, 885 F.2d 561 (9th Cir. 1989) (appreciation in value of securities); PLR 8940010 (Wash. lottery winnings).

[23] Wash. Rev. Code §26.16.030. *See White v. White*, 20 P.3d 481 (Wash. Ct. App. 2001).

[24] *See, e.g., McDonald v. Paine*, 119 Idaho 725, 810 P.2d 259 (1991) (mere expectancy is not community property); *Gessner v. Gessner*, 614 So.2d 307 (La. Ct. App. 1993) (professional degree is not property, so cannot be community property).

[25] *McClary v. Thompson*, 65 S.W.3d 829 (Tex. App. 2002) (retirement plan account); *Wood v. Wood*, 124 Idaho 12, 855 P.2d 473 (1993); *Nw Fin. v. Lawver*, 109 Nev. 242, 849 P.2d 324 (1993). Arizona considers whether receipts are "remuneratory" or gifts of appreciation from an employer. *Defrancesco v. Defrancesco*, 455 P.3d 722 (Ariz. Ct. App. 2019). Community property may arise although only one of the spouses is domiciled in a community property state. *See Fuori v. Fuori*, 334 So.2d 488 (La. Ct. App. 1976) (husband domiciled in Louisiana; wife resided in New York). *See also* TAM 9018002 (advising that surviving spouse in community property state has 50% interest in decedent spouse's profit-sharing account).

[26] *See Estate of Miles*, 72 Cal. App. 2d 336, 164 P.2d 546 (1945).

[27] The strength of the presumption for assets owned by married persons can vary among the states. *See Harry M. Cross*, *The Community Property Law in Washington*, 61 Wash. L. Rev. 13, 28 (1985). *See also Ariz. Cent. Credit Union v. Holden*, 6 Ariz. App. 310, 432 P.2d 276 (1967); *Haines v. Haines*, 39 Cal. Rptr.2d 673 (Ct. App. 1995); *Shill v. Shill*, 115 Idaho 115, 765 P.2d 140 (1988); *Stahl v. Stahl*, 91 Idaho 794, 430 P.2d 685 (1967); *Succession of Elrod v. Elrod*, 218 So.2d 83 (La. Ct. App. 1969); *Johnson v. Johnson*, 584 S.W.2d 307 (Tex. Civ. App. 1979); *Graham v. Radford*, 71 Wash.2d 752, 431 P.2d 193 (1967). Louisiana and Texas apply a rebuttable presumption that property "possessed" during marriage is community property. La. Civ. Code Ann. art. 2340; Tex. Fam. Code Ann. §3.003. *See Massey v. Massey*, 807 S.W.2d 391 (Tex. App. 1991), writ denied, 867 S.W.2d 766 (Tex. 1993); *Martinez v. Martinez*, 556 So.2d 668 (La. Ct. App. 1990).

[28] *Taylor v. Wilson*, 56 Nev. 353, 53 P.2d 339 (1936); *United States v. Moberg*, 227 F. Supp. 2d 1136 (E.D. Wash. 2002); *C & L Lumber & Supply, Inc. v. Tex. Am. Bank/Galeria*, 110 N.M. 291, 795 P.2d 502 (1990); *Kitchens v. Kitchens*, 407 S.W.2d 300 (Tex. Civ. App. 1966) (title in wife's name). For discussions of decisions regarding community gifts in pension and profit-sharing benefits, see *Fred Nordhauser, The Valuation of Defined Benefit Retirement Plan Benefits in Community Property Settlements*, 9 Cmty. Prop. J. 299 (1982); *William A. Reppy, Jr., Community and Separate Interests in Pension and Social Security Benefits After Marriage of Brown and ERISA*, 25 UCC L. J. 417 (1978); 814 T.M., *Estate and Gift Tax Issues for Employee Benefit Plans.*

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The commingling of separate with community property can result in a holding that all commingled property has become community property, unless the separate property proponent can clearly trace a separate property source to the commingled property.[29] If the commingled property cannot be segregated as to its sources so that its separate and community shares can be identified, then the entire mass is presumed to be community property.[30] This is the doctrine of commingling. However, if property can be traced to its source, its character will be the same as that of the property exchanged for it, regardless of the number of intervening transactions.[31]

2. Income of Separate Property

Income from separate property is considered separate property in most community property states (known as the "American rule"); however, in four community property states, the rents, issues, and profits of separate property are community property.[32] Whether the rule is applicable in the case of trust income appears to depend on whether the income beneficiary has any interest in the trust principal.[33]

3. Property Acquired Over Time

If property is acquired over a period of time when the purchaser was sometimes single and sometimes married, and the purchase price was paid with funds that include both community and separate property, there are three possible methods of characterizing the property. Community property states vary in their application of these methods. and states frequently apply different methods depending on the type of asset. The three methods are:

- inception of title (character is determined at the time the property is purchased even if the purchase price will be paid over time);
- time of vesting (character is determined as of time property vests in the purchaser, which in many installment contracts is at the time of last payment); and
- pro rata (character is allocated based on the percentage of funds the community and the separate estates paid toward the purchase price).

Real property purchased with a mortgage is often characterized using the time of inception of title.[34] The character of the property acquired with a mortgage, deed of trust or similar financing vehicle is determined by the character of the down payment made (if any) and the character of the credit pledged. Credit pledged by a married person is presumed to be community property.[35]

States vary greatly on characterization of life insurance. In Washington, whole life policies are divided on a pro rata approach, and proceeds of a policy are divided based on the nature of all of the premiums paid. Term life policies, on the other hand, are characterized by the nature of the last premium paid.[36] Idaho and Arizona also follow the last premium rule.[37]

The character of property acquired by adverse possession is often determined using time of vesting. When a trespasser enters property in adverse possession before marriage, but does not complete the possession until after marriage, the right is not deemed perfected until after marriage, and the property is considered community. If, however, the property is entered under claim of title before marriage, it has been held that the property is separate.[38]

Other assets commonly acquired over time that are subject to one of these methods include stock options, retirement accounts, contingent fees, and purchases under installment contracts. Some jurisdictions treat property acquired under an installment contract executed prior to the marriage and paid partly with community property as part community and part separate in proportion to the amount of different funds used.[39] In other states, such property may retain its character at the time of the contract (or at the time the right was completely perfected), and the marital community will have a right of reimbursement.[40]

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[29] *See Guthrie v. Guthrie*, 73 Ariz. 423, 242 P.2d 549 (1952); *In re Marriage of Marsden*, 130 Cal.App.3d 426 (1982); *Mitchell v. Mitchell*, 104 N.M. 205, 719 P.2d 432 (1986); *Estate of Tillotson*, No. 05-19-01192-CV, 2020 BL 506284, (Tex. App. Dec. 30, 2020); *Schwarz v. Schwarz*, 192 Wash. App. 180 (2017); *see also Stoutz v. United States*, 324 F. Supp. 197 (E.D. La. 1970) (La. law), aff'd per curiam, 439 F.2d 1197 (5th Cir. 1971); *Hundemer v. United States*, 293 F. Supp. 1063 (E.D. La. 1968) (La. law); *Claiborne v. Commissioner*, 40 B.T.A. 722 (1939); *Sweeney v. Commissioner*, 15 B.T.A. 1287 (1929).

[30] *Operation of Business: Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App. 1968) (operation of originally separate business); *accord Rowe v. Smith*, 73 Wash.2d 629, 440 P.2d 179 (1968). *Mixing property: Lawson v. Ridgeway*, 72 Ariz. 253, 233 P.2d 459 (1951); *Stahl v. Stahl*, 91 Idaho 794, 430 P.2d 685 (1967); *In re Estate of Witte*, 21 Wash.2d 112, 150 P.2d 595 (1944). *See also Flowers v. Flowers*, 118 Ariz. 577, 578 P.2d 1006 (Ct. App. 1978); *Lane v. Lane*, 375 So.2d 660 (La. Ct. App. 1978); *Malmquist v. Malmquist*, 106 Nev. 231, 792 P.2d 372 (1990); *Latham v. Allison*, 560 S.W.2d 481 (Tex. Civ. App. 1977); *In re Marriage of Chumbley*, 150 Wash.2d 1, 74 P.3d 129 (2003) (stock purchased using separate funds and community stock options to be divided upon rates of separate and community assets used to acquire stock at time it was purchased); *Estate of Frye v. Commissioner*, 44 B.T.A. 835 (1941) (Wash.). *But see In re Estate of Cudworth*, 133 Cal. 462, 65 P. 1041 (1901); *Stahl v. Stahl*, 91 Idaho 794, 430 P.2d 685 (1967) (mere commingling is not sufficient; tracing must be impossible); *Succession of Sonnier v. LeBleu*, 208 So.2d 562 (La. Ct. App. 1968) (only relatively small amount of community property involved).

[31] *Nace v. Nace*, 104 Ariz. 20, 448 P.2d 76 (1968); *Cargill v. Hancock*, 92 Idaho 460, 444 P.2d 421 (1968); *Newland v. Newland*, 529 S.W.2d 105 (Tex. Civ. App. 1975); *Schwarz v. Schwarz*, 192 Wash. App. 180, 368 P.3d 173 (2016).

[32] These jurisdictions are Idaho, Louisiana, Texas, and Wisconsin. Idaho Code §32-906; La. Civ. Code art. 2338, art. 2341; Tex. Fam. Code Ann. §3.001–§3.003; Wis. Stat. §766.31; *compare* Ariz. Rev. Stat. Ann. §25-213(A); Cal. Fam. Code §770(a); Nev. Rev. Stat. §123.130; N.M. Stat. Ann. §40-3-8(A), §40-3-8(E); Wash. Rev. Code §26.16.010.

[33] *See, e.g., Wilmington Tr. Co. v. United States*, 4 Cl. Ct. 6 (1983), aff'd, 753 F.2d 1055 (Fed. Cir. 1985).

[34] *E.g., Drahas v. Drahas*, 149 Ariz. 248, 717 P.2d 927 (Ct. App. 1985).

[35] *Marriage of Grinius*, 166 Cal. App.3d 1179, 212 Cal. Rptr. 803 (1985).

[36] *Aetna Life Ins. v. Wadsworth*, 102 Wash.2d 652, 689 P.2d 46 (1984); *Coffey's Estate*, 195 Wash. 379, 81 P.2d 283 (1938).

[37] *The Travelers Ins. Co. v. Johnson*, 97 Idaho 336, 544 P.2d 294 (1974); *Bell-Kilbournv. Bell-Kilbourn,* 216 Ariz. 521, 169 P.3d 111 (Ct. App. 2007).

[38] *Scott v. Washburn*, 324 S.W.2d 957 (Tex. Civ. App. 1959); *see generally* William Q. de Funiak & Michael J. Vaughn, Principles of Community Property (2d ed. 1971).

[39] *Bare v. Bare*, 256 Cal. App. 2d 684, 64 Cal. Rptr. 335 (1967); *Dougherty v. Miller*, 27 Wash.2d 11, 176 P.2d 335 (1947) (for real estate mortgage, source of down payment, fixed character of that pro rata portion, and nature of credit pledged determines remainder regardless of source of later funds). *But see Cargill v. Hancock*, 92 Idaho 460, 444 P.2d 421 (1968). *See also Malmquist v. Malmquist*, 106 Nev. 231, 792 P.2d 372 (1990) (algebraic formula applied).

[40] *Allen v. Allen*, 101 Tex. 362, 107 S.W. 528 (1908) (real estate); *Welder v. Lambert*, 91 Tex. 510, 44 S.W. 281 (1898) (contract to acquire land); *God-*

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4. Contributions of Community Property to Separate Property and Separate Property to Community Property

The character of property acquired with both separate and community funds is generally *pro tanto* separate and community.[41] Problems arise, however, when community property is used to improve separate property, or to make payments on a separate obligation, and vice versa. If uncompensated community labor or property is used to improve a spouse's separate property, this will usually give rise to a community property right to reimbursement protected by an equitable lien.[42] The value of the right to reimbursement, and whether any increase in value of the separate property is included, varies among the community property states. In Washington, for example, if community property funds were used to improve separate real estate, a share of the increased value of the property can be included in the community's right to reimbursement.[43] However when community funds are used to pay a portion of the mortgage owed on separate real property, the community only receives dollar for dollar reimbursement.[44] In California and Nevada, by contrast, the community is given a pro rata share in appreciation to the extent community property reduces principal owing on the separate property purchase price.[45] Community-funded improvements, however, are reimbursed only for out-of-pocket expenses unless it can be shown that the improvements directly increased the value.[46] In Texas, the community's recovery cannot exceed the amount of community funds expended.[47]

In any of these cases, the owner of the underlying property may be able to prove that the labor or funds contributed were intended as a gift to the underlying property holder and so defeat the right to reimbursement. When separate property of one spouse is used to improve community property or pay expenses of separate property of the other spouse, some states presume a gift to the community and require proof of an agreement to the contrary in order to reimburse the separate property.[48] The right to reimbursement may be offset by the value of any use of the property received by the contributor of the funds or labor. Thus, if community labor is expended to improve a separate property home of one of the spouses, presumptively triggering a right to reimbursement against the separate property owner, if the couple lives in the separate property house rent free, the rental value will be offset against the right to reimbursement and may well extinguish such a right.[49]

5. Business Entities Owned by Married Persons

The community property states differ on characterizing the increase in value during marriage of interests in separate property businesses. This issue is further complicated by the treatment of income from separate property as community property in some of the community property states. Louisiana has a statutory rule that enhancement of value of separate property is community property if the increase is the result of the spouse's labor.[50] If one spouse operates a business that is his or her separate property in a state which regards income from separate property as itself separate, an apportionment must be made between the income attributable to the personal efforts of this spouse and that attributable to the invested separate capital.[51] While proper apportionment is said to depend upon all the facts of the case, several apportionment formulae have emerged.[52] In

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dard v. Reagen, 8 Tex. Civ. App. 272, 28 S.W. 352 (1894) (time of acquisition determines character). *Public homesteads cases: In re Estate of Lamb*, 95 Cal. 397, 30 P. 568 (1892) (time of initiation controls); *accord Humbird Lumber Co. v. Doran*, 24 Idaho 507, 135 P. 66 (1913); *Card v. Cerini*, 86 Wash. 419, 150 P. 610 (1915). *Contra Doucet v. Fontenot*, 165 La. 458, 115 So. 655. *See generally* Note, *Characterization of Property in California When Period of Acquisition Overlaps Creation or Termination of Marital Community*, 17 Hastings L. J. 815 (1966). In all these cases, there would normally be a right of reimbursement for the improvements.

[41] *Nw & Pac. Hypotheek Bank v. Rauch*, 7 Idaho 152, 61 P. 516 (1900). *See, e.g., Hinckley v. Hinckley*, 583 So.2d 125 (La. Ct. App. 1991) (spouse who received half interest in house as inheritance from mother and purchased interest in other half from brother using community assets was entitled to 75% of sale proceeds as part of marital dissolution). The Louisiana Supreme Court lowered the standard of proof applicable to a spouse to prove the separate nature of property, from the "strict, clear, positive and legally certain" standard applied in *Hinckley*, to mere preponderance of the evidence. *Talbot v. Talbot*, 864 So.2d 590 (La. 2004).

[42] *Somps v. Somps*, 250 Cal. App.2d 328, 58 Cal. Rptr. 304 (1967); *Callnon v. Callnon*, 7 Cal. App.2d 676, 46 P.2d 988 (1935); *Wood v. Wood*, 124 Idaho 12, 855 P.2d 473 (1993); *Adkins v. Cason*, 170 So. 366 (La. Ct. App. 1936); *In re Marriage of Douthit*, 573 S.W.3d 927 (Tex. App. 2019) (governed by Tex. Fam. Code Ann. §3.402, party must show any enhanced value is directly attributable to community expenditures); *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935); *In re Estate of Kobylski v. Hellstern*, 178 Wis.2d 158, 503 N.W.2d 369 (Ct. App. 1993); *Conley v. Moe*, 7 Wash.2d 355, 110 P.2d 172 (1941). *See Horton v. Horton*, 35 Ariz. 378, 278 P. 370 (1929); *Williams v. Williams*, 199 So.2d 401 (La. Ct. App. 1967). *See generally* Richard W. Bartke, *Yours, Mine and Ours — Separate Title and Community Funds*, 44 Wash. L. Rev. 379 (1969), reprinted in 21 Baylor L. Rev. 137 (1969).

[43] *In re Marriage of Elam*, 97 Wn.2d 811, 650 P.2d 213 (1982).

[44] *In re Marriage of Wakefield*, 52 Wn. App. 647, 652, 763 P.2d 459 (1988). *See also Estate of Tillotson*, No. 05-19-01192-CV, 2020 BL 506284, (Tex. App. Dec. 30, 2020).

[45] *Marriage of Marsden*, 130 Cal. App.3d 426 (1982); *Marriage of Moore*, 28 Cal.3d 366 (1980); *Malmquist v. Malmquist*, 792 P.2d 372 (Nev. 1990). *See also Mohler v. Mohler*, 47 Cal.App.5th 788, 261 Cal.Rptr.3d 221 (App. 4th Dist. 2020) (following *Moore/Marsden* in its holding that "only the portion of community assets that is used to pay off loan principal is relevant to establishing the community interest in the property … [a]fter separation, however, the earnings and accumulations of a spouse are that spouse's separate property"; court distinguished between *Morre/Marsden* formula and *Watts* charges for one spouse's post-separation use of real property owned by community, whether wholly or partially).

[46] *Malmquist*, 792 P.2d 372.

[47] *See Pruske v. Pruske*, 601 S.W.2d 746 (Tex. Civ. App. 1980).

[48] *See, e.g., See v. See*, 64 Cal.2d 778, 415 P.2d 776 (1966); *Sparks v. Sparks*, 97 Cal. App.3d 353, 158 Cal. Rptr. 638 (1979) (where separate property was used to construct home on community realty, gift to community resulted); *In re Marriage of DeHollander*, 53 Wash. App. 695, 770 P.2d 638 (1989) (right of reimbursement may exist but probability of gift stronger than where community property is used to improve separate property).

[49] *Marriage of Miracle*, 101 Wash.2d 137, 675 P.2d 1229 (1984).

[50] La. Civ. Code Ann. art. 2368.

[51] *See, e.g., Todd v. Commissioner*, 153 F.2d 553 (9th Cir. 1945) (Cal. law); *In re Shafer*, 2 B.T.A. 640 (1925) (Wash.); *Lane v. Lane*, 375 So.2d 660 (La. Ct. App. 1978); Jensen v. Jensen, 629 S.W.2d 222 (Tex. App. 1982).

[52] In *Pereira v. Pereira*, 156 Cal. 1, 103 P. 488 (1909), the court allocated a "fair return" on the separate property investment as separate property and allocated the remainder to community property. *See Dekker v. Dekker*, 17 Cal. App.4th 842, 21 Cal. Rptr.2d 642 (1993); *Hybarger v. Hybarger*, 103 Nev. 255, 737 P.2d 889 (1987) (citing Pereira formula as "preferred" apportionment method in Nevada). In *Van Camp v. Van Camp*, 53 Cal. App. 17, 199 P. 885 (1921), the court determined the reasonable amount attributable to the spouse's labor and allocated that to community property, with the remainder allocated to separate property. A number of courts have held that whichever of these methods achieves "substantial justice" in the particular circumstances should be applied. *See, e.g., Cockrill v. Cockrill*, 124 Ariz. 50, 601 P.2d 1334 (1979); Beam v. Bank of Am., 6 Cal.3d 12, 490 P.2d 257 (1971); *Cord v. Neuhoff*, 94 Nev.

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Washington, the increase in the separate property business' value is separate unless the community was not sufficiently compensated for the spouse's labor through adequate salary. If the compensation was insufficient, then there was a community property interest acquired in the business that commingled and the result is that the business is now community property.[53] In California, apportionment depends on the cause of the increase in value. If the cause of the increase is the spouse's efforts, the separate property portion receives from the increase a reasonable rate of return and the rest is community property.[54] If the increase was due to the inherent nature of the business, the reasonable value of the spouse's services (if not already distributed to the community in the form of salary) is given to the community from the increase in value and the remainder is allocated to the separate property interest.[55] In Idaho, if the community was not adequately compensated for the spouse's labor, then the community is entitled to the difference between fair compensation and wages actually received, and no more.[56]

6. Retirement Benefits

Subject to federal preemption,[57] the community property interests of the spouses in pension and retirement benefits are determined under the general community property principles outlined above.[58] All states make some apportionment of the benefits but differ on when they use a time rule (percentage of time married over entire period of participation determines community share) or apportionment based on actual contribution. In states that treat income from separate property as community property, allocation can be even more complex.[59]

At various times, some states have followed the so-called "terminable interest rule," under which a nonemployee spouse's community property interest in pension benefits terminates at his or her death and, hence, is not subject to that spouse's testamentary disposition. Although the rule was adopted legislatively in Wisconsin, it was abrogated by statute in California.[60]

7. Tort Recovery

Rights to recover for tort may be either community or separate property depending on the nature of the right involved. In most jurisdictions, a recovery for personal injuries and pain and suffering is the separate property of the injured spouse, while a recovery for loss of earnings and expenses is regarded as community property.[61] In California, however, a right to recover for a tort suffered during marriage is community property without regard to the distinction between a recovery for expenses and a recovery for pain and suffering, but the recovery is allocated to the injured spouse upon dissolution in most cases.[62]

D. Agreements as to Status of Property

In most states, one spouse may make a gift of his or her interest in a community asset to the other spouse, thereby converting the entire asset into the separate asset of the donee spouse.[63] Spouses may agree that certain property is the separate property of one spouse. Spouses may also agree to transmute separate property to community property.[64]

21, 573 P.2d 1170 (1978). A good article on this subject is Donald B. King, *The Challenge of Apportionment*, 37 Wash. L. Rev. 483 (1962).

[53] *Hamlin v. Merlino*, 44 Wn.2d 851, 272 P.2d 125 (1954).

[54] *Pereira v. Pereira*, 103 P. 488 (Cal. 1909).

[55] *Van Camp v. Van Camp*, 199 P. 885 (Cal. 1921).

[56] *Speer v. Quinlan*, 96 Idaho 119, 525 P.2d 314 (1974).

[57] *See* II.I., below.

[58] *Carpenter v. Carpenter*, 150 Ariz. 62, 722 P.2d 230 (1986); *Maslen v. Maslen*, 121 Idaho 85, 822 P.2d 982 (1991); *McDonald v. Paine*, 119 Idaho 725, 810 P.2d 259 (1991); *Frazier v. Harper*, 600 So.2d 59 (La. 1992); *Eskine v. Eskine*, 518 So.2d 505 (La. 1988); *Kilgore v. Kilgore*, 449 P.3d 843 (Nev. 2019); *Gemma v. Gemma*, 105 Nev. 458, 778 P.2d 429 (1989); *Walsh v. Walsh*, 103 Nev. 287, 738 P.2d 117 (1987); *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988); *In re Marriage of Nuss*, 65 Wash. App. 334, 828 P.2d 627 (1992). *See* PLR 201623001 (community property interest in inherited individual retirement account (IRA) is matter of state property law and disregarded under §408), PLR 199937055 (classification of IRA as community property determined under state law).

[59] *See, e.g., Marriage of Maslen*, 121 Idaho 85 (1991).

[60] Wis. Stat. §766.31; Cal. Fam. Code §2610. *See Colvin v. Colvin*, 2 Cal. App. 4th 1570, 4 Cal. Rptr.2d 323 (1992); *Nice v. Nice*, 230 Cal. App. 3d 444, 281 Cal. Rptr. 415 (1991). *But see Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991) (Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. No. 93-406, preempts California community property law, in that predeceasing nonemployee spouse has no right to dispose of employee spouse's pension benefits by will). Ablamis is discussed below. *See also Ashabraner v. Estate of Chatelain*, Nos. B285456, B288714, 2019 BL 232453 (Cal. App. June 24, 2019), modified by No. B285456 c/w B288714, 2019 BL 234658, cert. denied No. S257259, 2019 BL 345412 (Sept. 11, 2019) (where wife predeceased husband, and both husband and wife died intestate, wife's sister did not have claim to husband's retirement savings account or deferred compensation plan through wife's community property rights; such rights ended at wife's death).

[61] La. Civ. Code Ann. art. 2344; *Jurek v. Jurek*, 124 Ariz. 596, 606 P.2d 812 (1980); *Rogers v. Yellowstone Park Co.*, 97 Idaho 14, 539 P.2d 566 (1974), *Roge v. Roge*, 604 So.2d 721 (La. Ct. App. 1992); *Meagher v. Garvin*, 80 Nev. 211, 391 P.2d 507 (1964); *Russell v. Russell*, 106 N.M. 133, 740 P.2d 127 (Ct. App. 1987); *Moreno v. Alejandro*, 775 S.W.2d 735 (Tex. App. 1989); Graham v. Franco, 488 S.W.2d 390 (Tex. 1972); *In re Marriage of Brown*, 100 Wash.2d 729, 675 P.2d 1207 (1984).

[62] Cal. Fam. Code §780–§783.

[63] Note that there may be specific requirements meant to notify the transferring spouse that the transfer will remove his or her rights to the community property. *See Begian v. Sarajian*, 31 Cal. App. 506, 242 Cal. Rptr.3d 692 (2018), citing Cal. Fam. Code §852(a). *See also* Tex. Fam. Code Ann. §4.205 (requiring specific language in transferring document).

[64] *See In re Marriage of Cupp*, 152 Ariz. 161, 730 P.2d 870 (1986).

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All community property states now recognize the right of spouses to enter into premarital and postmarital agreements governing their respective rights in property. The right to govern property interests by premarital agreement has long been recognized in California,[65] Idaho,[66] Nevada,[67] New Mexico,[68] Arizona,[69] and Washington.[70] Legislation in Louisiana[71] and Texas[72] has broadened the powers of spouses to enter into premarital agreements in those jurisdictions. Postmarital agreements are valid in California,[73] Nevada,[74] New Mexico,[75] and Washington,[76] and former restrictions have been dropped by legislation in Arizona,[77] Idaho,[78] Louisiana,[79] and Texas.[80] The states vary on the formalities required. Changing the character of property owned by one or both spouses is called "transmutation." Louisiana requires a married couple to get court approval of any agreement that eliminates community property, but a couple may enter into a prenuptial agreement without court approval, and a couple moving to Louisiana has a limited time to enter into such an agreement before the court approval requirement is triggered. Spouses are allowed to partition community assets into separate property without court approval.[81] Texas has specific requirements for any agreement converting separate property to community property.[82] California requires a writing for a transmutation of property.[83] In Washington, couples may recharacterize assets as community or separate by oral or written agreement.[84]

In Idaho, Washington, Texas and Wisconsin, spouses can enter into agreements that provide for the disposition of community property at death.[85] In Washington, Wash. Rev. Code §26.16.120 provides that spouses (or registered domestic partners) can enter into an agreement that determines the disposition of the community property on the death of the first spouse (or registered domestic partner) to die. In Idaho, Idaho Code §15-6-201 allows such agreements that would apply to separate as well as community property but requires specific descriptions of real property to be included, so such an agreement cannot be used to cover after-acquired real estate. Wis. Stat. §766.58 allows a broad marital property agreement that can direct either separate or community property, including after acquired property, to pass to a designated person, trust or other entity. Generally, all of these agreements are automatically revoked upon divorce of the couple.

If state law permits premarital or postmarital agreements affecting the character of property owned or acquired during the marriage, such agreements are given effect for income tax purposes.[86]

E. Management of Community Property

Both spouses have a presently vested, equal, undivided interest in all community property.[87] Traditionally, the husband had the power of management and control over nearly all community property.[88] All community property jurisdictions have abandoned this approach in favor of equal authority of the spouses.[89] Thus, there are three types of management for property owned by a married person in a community property state. First, equal management means that either spouse acting alone may manage and control community property. Second, joint management requires that both spouses join in any action regarding the property. Finally, exclusive management means that only one spouse has the authority to manage and control the property under exclusive management. Each state has different approaches to applying these three types of management,

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[65] *See Wahlefeld v. Wahlefeld*, 105 Cal. App. 770, 288 P. 870 (1930); *Martin v. Pritchard*, 52 Cal. App. 720, 199 P. 846 (1921). Premarital agreements may cover after-acquired property, as well as property owned at the date of execution. *Tompkins v. Bishop*, 94 Cal. App.2d 546, 211 P.2d 14 (1949). A premarital agreement provision that earnings during marriage are the earning spouse's separate property is valid. *Cheney v. City & Cnty. of S.F.*, 7 Cal.2d 565, 61 P.2d 754 (1936). Transmutation of a house from community property into the wife's separate property under a marital agreement is valid, despite the fact that the husband later lived in the house. *Roosevelt v. Finalco*, 87 F.3d 311 (9th Cir. 1996) (Cal.), overruled on other grounds, *Murray v. Bammer*, 131 F.3d 788 (9th Cir. 1997).

[66] *See, e.g., Jones v. Jones*, 100 Idaho 510, 601 P.2d 1 (1979).

[67] Nev. Rev. Stat. tit. 11, §123A.010–§123A.100, et seq.

[68] *See, e.g., English v. Sanchez*, 110 N.M. 343, 345, 796 P.2d 236, 238 (1990); *Chavez v. Chavez*, 56 N.M. 393, 244 P.2d 781 (1952). *See also* N.M. Stat. Ann. §40-3-8, §40-3A-1 et. seq.

[69] *But see Williams v. Williams*, 29 Ariz. 538, 243 P. 402 (1926).

[70] *Johnson v. Dar Denne*, 161 Wash. 496, 296 P. 1105 (1931). *See Harry M. Cross, The Community Property Law in Washington*, 15 Wash. L. Rev. 640 (1955). To be upheld, a premarital agreement that fails to make a fair and reasonable provision for the party not seeking enforcement must be based, inter alia, upon full disclosure of both parties' assets, full knowledge of individual rights, and independent advice. *In re Marriage of Matson*, 107 Wash.2d 479, 730 P.2d 668 (1986). *See In re Estate of Crawford*, 107 Wash.2d 493, 730 P.2d 675 (1986).

[71] La. Civ. Code Ann. art. 2329. *See* Janet Mary Riley, *Analysis of the 1980 Revision of the Matrimonial Regimes Law of Louisiana*, 26 Loy. L. Rev. 453 (1980).

[72] Tex. Const. art. XVI, §15. *See Winger v. Pianka*, 831 S.W.2d 853 (Tex. App. 1992).

[73] Cal. Fam. Code §720, §721, §850–§853. *See Valli v. Valli*, 58 Cal.4th 1396, 324 P.3d 274 (2014); *Estate of MacDonald v. MacDonald*, 51 Cal.3d 262, 794 P.2d 911 (1990). *Burkle v. Burkle*, 144 Cal. App. 4th 387 (2006) (unpub. op.) contains a summary of the law.

[74] Nev. Rev. Stat. tit. 11, §123.070. *See, e.g., Walker v. Walker*, 41 Nev. 4, 164 P. 653 (1917), amended, 41 Nev. 12, 169 P. 459 (1918).

[75] N.M. Stat. Ann. §40-2-2.

[76] Wash. Rev. Code §26.16.050 (realty); *State ex rel. Van Moss v. Sailors*, 180 Wash. 269, 39 P.2d 397 (1934) (personalty).

[77] *Noble v. Noble*, 26 Ariz. App. 89, 546 P.2d 358 (1976).

[78] Idaho Code §32-906(1). Idaho law requires a written instrument to transmute the character of realty. *See, e.g., Griffin v. Griffin*, 102 Idaho 858, 642 P.2d 949 (Ct. App. 1982).

[79] La. Civ. Code Ann. art. 2329. Restrictions remain. *See Janet Mary Riley, Analysis of the 1980 Revision of the Matrimonial Regimes Law of Louisiana*, 26 Loy. L. Rev. 453 (1980).

[80] Tex. Const. art. XVI, §15.

[81] La. Civ. Code Ann. arts. 2328–2336.

[82] Tex. Fam. Code Ann. §4.203.

[83] Cal. Fam. Code § 852(a).

[84] *Marriage of Mueller*, 140 Wn. App. 498, 167 P.3d 568 (2007).

[85] *See, e.g.*, Tex. Const. art. XVI, §15; Tex. Est. Code §112.051; Wash. Rev. Code §26.16.120; *see also Haynes v. Stripling*, 812 S.W.2d 397 (Tex. App. 1991).

[86] Rev. Rul. 77-359 (Wash.); Rev. Rul. 73-391 (Cal. law); *Aronow v. Commissioner*, T.C. Memo 1970-246 (Cal. law); *Estate of Crail v. Commissioner*, 46 B.T.A. 658 (1942) (Cal. law). *See* PLR 8037124 (execution of postmarital agreement converting community property into equal shares of separate property not a taxable event).

[87] *See, e.g., Bishop v. Commissioner*, 152 F.2d 389 (9th Cir. 1945); *McNabney v. McNabney*, 105 Nev. 652, 782 P.2d 1291 (1989); PLR 8016050.

[88] *See, e.g., Mortensen v. Knight*, 81 Ariz. 325, 305 P.2d 463 (1956); *Camel v. Waller*, 526 So.2d 1086 (La. 1988) (describing former law under which husband was "head and master" of marital property).

[89] Ariz. Rev. Stat. Ann. §25-214(B); Cal. Fam. Code §1100; Idaho Code §32-912; La. Civ. Code Ann. art. 2346; Nev. Rev. Stat. tit. 11, §123.230; N.M. Stat. Ann. §40-3-14(A); Texas Fam. Code Ann. §3.102(a); Wis. Stat. §766.51; Wash. Rev. Code §26.16.030.

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and each will use the three types depending on the type of asset or transaction.

In most of the community property states, the general rule, subject to the exceptions that require joinder or exclusive control by one spouse, is that each spouse has equal power unilaterally to deal with community property, with a somewhat undefined fiduciary duty to act in the other spouse's best interests.[90] The most common use of joint management is for transactions regarding community real property.[91] For example, in Arizona, "joinder of both spouses is required in … [a]ny transaction for the acquisition, disposition or encumbrance of an interest in real property other than an unpatented mining claim or a lease of less than one year."[92] In addition, gifts of community property usually require the joinder of both spouses.[93] However, some states allow "reasonable" gifts to be made unilaterally.[94] One spouse may gift his or her interest in community property to the other, making that property the separate property of the donee spouse. A court may also find a gift if separate funds of one spouse or community funds are used to acquire personal adornment items (such as jewelry) for the other spouse.[95]

Most states with equal management as the general rule provide that if one spouse operates a community property business, that spouse has exclusive management over the business assets except for a disposition of substantially all of the business assets.[96]

Texas and Wisconsin follow a different approach from the equal management states. Generally, spouses have exclusive management over assets that are in that spouse's name alone or are assets that would be the spouse's own property if he or she was not married.[97] Otherwise, community property is subject to joint management. Wisconsin has an "add a name" procedure where a spouse can ask a court to add his or her name to an asset to convert management from exclusive control of the spouse holding title to joint management of both spouses.[98]

[90] *See, e.g.*, Cal. Fam. Code § 721.

[91] *See, e.g.*, *Geronimo Hotel & Lodge v. Putzi*, 151 Ariz. 477, 728 P.2d 1227 (1986) (under Ariz. Rev. Stat. Ann. §25-214, transfer of community realty by one spouse is voidable by other spouse); *Hyatt v. Mabie*, 24 Cal. App.4th 541, 29 Cal. Rptr.2d 447 (1994) (nonconsenting spouse can only invalidate encumbrance on community realty to extent of spouse's community property interest); *Droeger v. Friedman, Sloan & Ross*, 54 Cal.3d 26, 283 Cal. Rptr. 584 (1991) (under former Cal.Civ. Code §5127 [now Cal. Fam. Code §1102], transfer of community realty without spousal consent is voidable; after 2014, there is a one-year limit after recordation of the deed); *Roselli v. Rio Communities Serv. Station, Inc.*, 109 N.M. 509, 787 P.2d 428 (1990) (under N.M. Stat. Ann. §40-3-14, gift of substantial community property by one spouse may be set aside by other spouse); *Co. Nat'l Bank v. Merlino*, 35 Wash. App. 610, 668 P.2d 1304 (1983) (Wash. Rev. Code §26.16.030 requires consent of both spouses for acquisition of community real property).

[92] Ariz. Rev. Stat. Ann. § 25-214(C)(1).

[93] *E.g.*, Wash. Rev. Code §26.16.030(2).

[94] *E.g.*, Wis. Stat. § 766.53.

[95] *Johnson v. Dar Denne*, 161 Wash. 496, 296 P. 1105 (1931).

[96] Cal. Fam. Code §1100; La. Civ. Code Ann. art. 2350. La. Civ. Code Ann. art. 2355.1 provides for judicial authorization to permit one spouse to manage the community property if the other spouse is an "absent person." La. Civ. Code Ann. art. 2355 empowers the court to permit one spouse to manage the community exclusively if the other spouse arbitrarily refuses to concur in management decisions. *See Allen v. Allen*, 611 So.2d 790 (La. Ct. App. 1992).

[97] *E.g.*, Tex. Fam. Code Ann. §3.102; Wis. Stat. §766.51, §766.53.

[98] Wis. Stat. §766.70-3.

Regardless of management control, each spouse owes fiduciary duties to the other when dealing with community property.[99]

F. Debts and Liabilities

The ability of creditors to collect against a married person's property is another area of variation among the community property states. Arizona, New Mexico, and Washington follow the "community debt" system. Under that approach, a debt is first characterized as community or separate.[100] A debt incurred before marriage is necessarily separate, and the characterization of a debt incurred during marriage depends on the purpose of the debt. Torts are particularly troublesome because the tortfeasor spouse would not have committed the tort "for the benefit of the community" in most instances (although it is easier to characterize as such if the tort is fraud or similar financial misdeed). However, if the tort was committed in the course of managing the community or earning money for the community, it is likely to be characterized as community debt.[101] A debt incurred by a spouse is generally enforceable against that spouse's separate property and, if a community debt, against the community property. A separate debt is generally only collectible against the debtor spouse's separate property, and often there is no separate property. In Washington, if there is a separate tort debt and insufficient separate funds to satisfy the debt, the tort creditor can collect from the tortfeasor spouse's one-half of the community property.[102] In New Mexico, separate debts are defined very narrowly and are generally just premarital debts, debts that are specified in writing to the creditor as separate debts and debts that are "unreasonable."[103] It is therefore easier for a creditor in New Mexico to collect from community property.

Under Arizona law, all debts incurred during marriage are, in general, presumptively community debts in the absence of clear and convincing evidence to the contrary.[104] However, a debt incurred by one spouse in Arizona can, depending on the circumstances, constitute a separate debt rather than a community debt.[105] Arizona law also permits a creditor on a premarital obligation to reach the debtor spouse's interest in the community property.[106]

[99] *See In re Marriage of Matson*, 107 Wash.2d 479, 730 P.2d 668 (1986); Wis. Stat. §766.15.

[100] *See Harry M. Cross, The Community Property Law in Washington*, 61 Wash. L.Rev. 13, 114 (1985).

[101] *See Elia v. Pifer*, 194 Ariz. 74, 977 P.2d 796 (1998); *Clayton v. Wilson*, 168 Wash.2d 57, 227 P.2d 278 (2010).

[102] *deElche v. Jacobsen*, 95 Wash.2d 237, 622 P.2d 835 (1980). *See also In re Estate of Haave v. Haave*, No. 56887-0-II, 2023 BL 174946 (Wash. Ct. App. May 23, 2023) (personal representative's liability extended from breach of fiduciary duty in failing to pay creditor and instead distributing funds to himself and commingling in community property account; because such liability "aptly sounds in tort," creditor could recover from community property account).

[103] N.M. Stat. Ann. §40-3-9(A).

[104] *Schlaefer v. Fin. Mgmt. Serv., Inc.*, 996 P.2d 745 (Ariz. Ct. App. 2000) (medical debt incurred during marriage).

[105] *Vance-Koepnick v. Koepnick*, 3 P.3d 1082 (Ariz. Ct. App. 1999) (debt incurred by husband for attorneys' fees in preserving separate nature of husband's interest in corporation, and guaranty signed in connection with loan to corporation, constitute husband's separate debts).

[106] Ariz. Rev. Stat. Ann. §25-215(B).

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The second approach, followed in the remainder of community property states, is the "managerial system." Under this system, liability follows management and control, so the creditor of a spouse can, with some exceptions, collect from any property that the spouse can manage and control, under the rules described in the previous system.[107] The Idaho courts have held the community property liable for separate debts.[108] Community property is also liable for a separate debt in Louisiana,[109] subject to a right of reimbursement in the nondebtor spouse at dissolution.[110]

Practice Tip: Note that while state law applies to determine what rights, title, or interest a taxpayer has in property, under §6321 the IRS has a lien on all property and rights to property belonging to a delinquent taxpayer.[111] In addition, §6331(a) authorizes levies on all property and rights to property belonging to such a taxpayer. The IRS may seek to foreclose on federal tax liens under §7403 against "any property, of whatever nature, of the delinquent, or in which he has any right, title, or interest."[112]

Debts from one jurisdiction enforceable in a second jurisdiction may be subject to the differing law in two jurisdictions. If the community property laws of different jurisdictions produce different results, a conflict of law analysis usually results. For a discussion on the analysis, see II.H., below.

G. Dissolution of the Community

Community property division upon divorce varies from state to state.[113] The division of community property in a divorce may be affected by pre- or postnuptial agreement terms.[114]

If a marriage is dissolved, all community property not allocated between the former spouses by the dissolution decree will be owned by them as tenants in common.[115] After the dissolution, either spouse as co-tenant may bring an action to partition the property held in common.[116]

Editor's Note: An Arizona court held that community property divided at dissolution should provide each spouse with "an immediate, present, and vested separate property interest in the property awarded" thereto. The appellate court reversed the lower court's holding that two pieces of real property should be held by divorcing spouses as joint tenants in common with right of survivorship for six years until the children graduated high school and held that both spouses' property rights required that the real property be sold and proceeds divided equally among the spouses.[117]

The timing of the dissolution of the community property regime formally occurs at different points in the divorce process in different states.[118] In some states, the community relationship is not dissolved upon the granting of a legal separa-

[107] *See, e.g.*, Cal. Fam. Code §1102(a); Nev. Rev. Stat. §123.230. *See also In re Ton*, No. 22-30378, 2023 BL 105109 (5th Cir. Mar. 29, 2023) (where debtor spouse plead guilty to tax fraud and agreed to repay tax liability and non-debtor spouse filed for divorce one month later, non-debtor spouse's half of community property remained liable for creditor's claims arising from debtor spouse's tax liability, including loans taken out years after divorce to resolve such tax liability; court cited *In re Robertson*, 203 F.3d 855 (5th Cir. 2000), for proposition that "[a]n obligation incurred by a spouse before or during the community property regime may be satisfied after termination of the regime from the property of the former community and from the separate property of the spouse who incurred the obligation"); *In re Brace*, 470 P.3d 15 (Cal. 2020) (bankruptcy trustee could reach entirety of both spouses' real property interests (one property acquired in 1977 and other acquired pre-bankruptcy) where one spouse declared bankruptcy, other spouse refused to join bankruptcy petition, and court held presumption existed that joint tenancy property acquired with community funds after 1974 was community in character, while joint tenancy property acquired during marriage before 1975 was presumptively separate in character).

[108] *Williams v. Paxton*, 98 Idaho 155, 559 P.2d 1123 (1976); *Gustin v. Byam*, 41 Idaho 538, 240 P. 600 (1925).

[109] La. Civ. Code Ann. art. 2345. *But see Tri-State Bank & Tr. v. Moore*, 609 So.2d 1091 (La. Ct. App. 1992) (separate property of spouse who did not incur community debt cannot be seized to satisfy such debt; spouse did not sign notes to satisfy community property debt).

[110] La. Civ. Code Ann. art. 2364.

[111] *See Sohn v. United States*, 723 F. Supp. 3d 763 (N.D. Cal. 2024) (finding federal lien properly attached to personal residence under §6321 where state law provides community property is liable for debt of spouse).

[112] In determining whether property is considered separate or community, four states (Texas, Arizona, Louisiana, and New Mexico) employ a "inception-of-title" theory of property. *See, e.g.*, *United States v. Orr*, 336 F. Supp. 3d 732 (W.D. Texas 2018) (using Texas' inception-of-title rule, court held that real property constituted community property and was therefore subject to IRS lien). For the differences in property ownership in inception of title states, see IV.J.7.e., below. For further discussion on federal tax collection in community property states, see 637 T.M., *Federal Tax Collection Procedure — Liens, Levies, Suits and Third Party Liability* (U.S. Income Series).

[113] *See, e.g.*, Idaho Code §32-712 (substantially equal, considering debt and other factors); La. Rev. Stat. Ann. §9:374(E)(2) (considering factors relevant to each spouse's needs, and children's needs); Nev. Rev. Stat. tit. 11, §125.150(1)(b) (equal disposition exception for compelling reasons to make unequal disposition). In *Kogod v. Cioffi-Kogod*, 439 P.3d 397 (2019), the Nevada Supreme Court found as a "compelling reason" for unequal division of the community property the husband's expenditures on a second family and gifts to relatives. These factors were distinct from any alimony award. However, the court considered the earning power of the community property award to the wife to determine that she did not need alimony.

[114] For a discussion on the impact of interspousal agreements, see IV.A., below.

[115] *See, e.g.*, Idaho Code §15-6-402(2); Nev. Rev. Stat. tit. 10, §111.781(1)(b); *Dempsey v. Oliver*, 93 Ariz.238, 379 P.2d 908 (1963); *Becker v. Becker*, 36 Cal.2d 324, 223 P.2d 479 (1950); *First Nat'l Bank v. Wolff*, 66 Nev. 51, 202 P.2d 878 (1949); *Ex parte Williams*, 160 Tex. 314, 330 S.W.2d 605 (1960); *Yeats v. Estate of Yeats*, 90 Wash.2d 201, 580 P.2d 617 (1978); *Ambrose v. Moore*, 46 Wash. 463, 90 P. 588 (1907); *Barros v. Barros*, 34 Wash. App. 266, 660 P.2d 770 (1983). *See also, e.g.*, *In re Marriage of Brewer*, 137 Wash.2d 756, 976 P.2d 102 (1999) (payments to disabled spouse under disability insurance policy after marriage dissolved constitute separate property).

[116] *Loston v. Loston*, 424 S.W.2d 316 (Tex. Civ. App. 1968).

[117] *Dole v. Blair*, 463 P.3d 849 (Ariz. Ct. App. Div. 1 2020) (court noted that although best interests of children should be factor, children's interests could not trump father's property rights; court also held that spouses would hold titles as tenants in common until real property interests were sold). *See also In re Niemi*, 496 P.3d 305 (Wash. Ct. App. 2021) (where trial court awarded family dogs to Spouse A as his separate property in dissolution proceedings but ordered that Spouse B could visit dogs on set visitation schedule, appellate court held that trial court erred in granting Spouse B visitation rights because (i) Washington has not recognized animals as special category of property, (ii) family dogs, therefore, constituted separate property, and (iii) Spouse A had right to have his separate property interest "definitely and finally determined" without prospect of future litigation and Spouse B's visitation rights would likely result in continuing enforcement and supervision problems).

[118] *Compare* Cal. Fam. Code §771 (providing a "date of separation," determined by case facts; *see, e.g.*, *In re Marriage of Lehman*, 955 P.2d 451 (Cal.1998)); La. Civ. Code Ann. art. 159 (termination retroactively to date of petition filing).

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tion,[119] but rather only divorce or the death of one party terminates the community relationship.[120]

If community property was created in a marriage that is later annulled, the property may still be subject to division using the community property rules.[121]

A Nevada statute authorizes the court to divide community property in the event of a spouse's incapacity.[122]

Under Washington law, the slaying of one spouse by the other does not forfeit the slayer's community property interest.[123]

H. Choice of Law Problems

Choice of law problems[124] arise frequently when property is moved from one jurisdiction to another. Under the general rule, the character of movable property is fixed at the time of acquisition in accordance with the law of the marital domicile.[125] Therefore, if the parties are domiciled in a community property state, the status of movable property acquired during marriage is determined by the community property law of that state. The character of real property is generally determined by the law of the situs.[126] However, if community funds are used to purchase real property in a common law property state, the common law jurisdiction will respect the interests of the spouses in that property, even though the exact community nature is not recognized by that jurisdiction.[127] In such a case, for instance, the interest of the wife may be protected by the use of a resulting trust theory.[128] The nature of property remains the same regardless of movement from one jurisdiction to another.[129] If, when a couple is domiciled in a common law property jurisdiction, property that was originally community property is exchanged for other property, the ownership interests in the newly acquired asset will be determined according to the law of that jurisdiction. However, the interests of the parties will be recognized even though, strictly speaking, the new property is no longer community property.[130]

A number of states treat acquisitions made by a married couple domiciled in a community property state of property outside the state that would have been community property had they been acquired in-state as "quasi-community property," which is treated for specified purposes as if it were community property.[131] In community property states, because the spouse obtains an interest in the earnings of the other during the marriage, there is less protection for the spouse at the end of the marriage than there is in common law states. For example, in all common law states other than Georgia, a surviving spouse has the right to an elective share in the deceased spouse's estate, regardless of the provisions of the deceased spouse's estate plan. However, in community property states the surviving spouse has no such rights in the deceased spouse's estate. In all of the community property states, the deceased spouse can dispose of his or her one-half of the community by death without any provision for the surviving spouse. At divorce, common law states allow division of the couple's property, but in community property states courts have either no discretion or limited discretion in dividing separate property. With such a disparity in the timing of protection, if a couple moves from a common law state to a community property state and then the marriage ends, the poorer spouse may be disadvantaged. Quasi-community property statutes have been adopted to address that problem. For example, in California, Idaho, Louisiana and Washington, the separate property of one spouse that was acquired by that spouse while married and domiciled in a noncommunity property state, and that would have been community property had the acquiring spouse been a domiciliary of a community property state at the time of its acquisition, is qua-

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[119] *Cohn v. Cohn*, 4 Wash.2d 322, 103 P.2d 366 (1940). *See Rodieck v. Rodieck*, 9 Ariz. App. 213, 450 P.2d 725 (1969) (various cases cited; decree of separation from bed and board does not dissolve community). In New Mexico, it is not clear whether separation alone dissolves the community property relationship. *See* N.M. Stat. Ann. §40-3-8. *Compare* R. Dale Swigart, *Federal Taxation of New Mexico Community Property*, 3 Nat. Res. J. 104, 153–54 (1963) *with* Robert Emmet Clark, Community of Property and the Family in New Mexico, 25, 44 (1956).

[120] *See* La. Civ. Code art. 159. Louisiana law's forced-share provisions may afford significance to the community property classification long after death. *See Estate of Gibson v. Commissioner*, 65 T.C. 813 (1976) (Louisiana law assumes that imperfect usufruct may create claims on part of forced heirs that may be deductible under §2053).

[121] *See, e.g., Hammett v. Hammett*, 453 P.3d 1145 (Ariz. App. Oct. 29, 2019). For a discussion on void marriages and community property, see II.B., above.

[122] Nev. Rev. Stat. tit. 11, §123.259.

[123] *Armstrong v. Bray*, 826 P.2d 706 (Wash. Ct. App. 1992).

[124] *See generally* Harold Marsh, Marital Property in Conflict of Laws (1952); Norvie L. Lay, *Community Property in Common Law States: A Comparative Analysis of Its Treatment in Foreign Jurisdictions*, 41 Temp. L. Q. 1 (1967); Karen E. Boxx, *Community Property across State Lines*, Prob. and Prop. (Jan/Feb. 2005).

[125] Cal. Fam. Code §760; *Rau v. Rau*, 6 Ariz. App. 362, 432 P.2d 910 (1967); *Rozan v. Rozan*, 49 Cal.2d 322, 317 P.2d 11 (1957); *Razzaghe-Ashrafi v. Razzaghe-Ashrafi*, 558 So.2d 1368 (La. Ct. App. 1990); *In re Marriage of Landry*, 103 Wash.2d 807, 699 P.2d 214 (1985). Therefore, if a New York domiciliary buys land in Washington with funds from his earnings in New York, the land would be considered his separate property in Washington, even though had he lived in Washington, it would be community property. *Brookman v. Durkee*, 46 Wash. 578, 90 P. 914 (1907), *accord Blethen v. Bonner*, 71 S.W. 290 (Tex. Civ. App. 1902). Likewise, debts contracted in a common law property state by a spouse domiciled in a community property state may be enforceable against the community property. *Bainum v. Roundy*, 21 Ariz. App. 534, 521 P.2d 633 (1974).

[126] Restatement (Second) of Conflicts §223 (1971).

[127] *Quintana v. Ordono*, 195 So.2d 577 (Fla. Dist. Ct. App. 1967). A number of common law property states have enacted a statutory solution to many of these problems, the Uniform Disposition of Community Property Rights at Death Act, including: Alaska Stat. §13.41.005 to §13.41.005; Ark. Code Ann. §28-12-101 to §28-12-113; Colo. Rev. Stat. §15-20-101 to §15-20-111; Conn. Gen. Stat. §45a-458 to §45a-466; Florida Stat. §732.216 to 732.228; Haw. Rev. Stat. §510-21 to §510-30; Ky. Rev. Stat. Ann. §391.210 to §391.260; Mich. Comp. Laws §557.261 to Mich. Comp. Laws §557.271; Minn. Stat. §519A.01 to §519A.11; Mont. Code Ann. §72-9-101 to §72-9-120; N.Y. Est. Powers & Trusts Law §6-6.1 to §6-6.7; N.C. Gen. Stat. §31C-1 to §31C-12; Or. Rev. Stat. §112.705 to §112.775; Utah Code Ann. §75-2b-101 to §75-2b-101; Va. Code Ann. §64.2-315 to §64.2-324; Wyo. Stat. §2-7-720 to §2-7-729. *See* Cantwell & Cox, *Community Property for Every Lawyer*, 3 Colo. Law. 321 (1974). For a map of states that have adopted the Uniform Disposition of Community Property Rights at Death Act, see the Uniform Law Commission's website, www.uniformlaws.org.

[128] Even in states where the purchase-money resulting trust has been abolished, the same protection should be afforded the spouse under the confidential relationship constructive trust doctrine.

[129] *Rau v. Rau*, 6 Ariz. App. 362, 432 P.2d 910 (1967); *Moore v. Ferrie*, 14 Cal. App. 4th 1472, 18 Cal. Rptr.2d 543 (1993); *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803.

[130] *Quintana v. Ordono*, 195 So.2d 577 (Fla. Dist. Ct. App. 1967).

[131] *See* Thomas R. Andrews, *Washington's New Quasi-Community Property Act: Protecting the Immigrant Spouse*, 15 Cmty. Prop. J. 50 (1988). *See also* Ariz. Rev. Stat. Ann. §25-318(A); Cal. Fam. Code §125; N.M. Stat. Ann. §40-3-8(C), N.M. Stat. Ann. §40-3-8(D); Wash. Rev. Code §26.16.220–§26.16.250.

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si-community property. When one spouse dies owning quasi-community property, the surviving spouse is entitled to one-half of the quasi-community property and the remainder is disposed of in the deceased spouse's estate.[132] In Arizona, California, Louisiana, New Mexico and Texas, where the courts are given less discretion in the division of property upon divorce, property that would have been community property if acquired while the couple lived in a community property state is quasi-community property and is divided the same as community property upon divorce.[133]

Any of the rights created by the quasi-community property statutes can be waived, modified or relinquished by a written agreement that is signed by both spouses or registered domestic partners. Duly executed community property agreements, prenuptial and postnuptial agreements, and agreements as to status of property may affect these rights, whether executed before or after the effective date of the quasi-community property statutes.

Furthermore, spouses may be able to choose whether common law or community property law applies to a specific asset. For example, *Estate of Richman v. Commissioner*[134] held that a choice of law clause in the governing document of a Massachusetts business trust controlled the spouses' ownership interests under Texas conflict of law principles. The court rejected the IRS's attempts to invalidate the choice of Massachusetts law by arguing that the application of Massachusetts law would contravene a "fundamental policy" of Texas law.

When spouses are domiciled in two different states, the character of property is in general to be determined by the law of the state in which the spouse who acquired the property was domiciled at the time the property was acquired.[135]

The status of property acquired by either spouse while married and domiciled in a common law property state is determined by the law of that state, regardless of a subsequent move or transfer to a community property state.[136] In general, property acquired while the spouses are domiciled in a common law property state is not community property, although if it is acquired in exchange for community property, the other spouse's interest can be protected.[137]

Due to the increased mobility of the population and expanding business opportunities globally, the question of whether the debts and liabilities of one spouse, incurred in one jurisdiction, can reach community property assets, located in another jurisdiction, may also be governed by the choice of law and the applicable conflict of law rules of the assets' location. If the community property laws of different jurisdictions produce different results, a conflict of law analysis usually results.[138]

I. Federal Preemption

The circumstances under which federal statutes conferring benefits on one spouse preempt state community property laws continue to be the subject of litigation.[139] Benefits under the Railroad Retirement Act[140] have been held not to be subject to distribution as community property on dissolution.[141] However, federal law allows federal and state courts to apply community property laws to military retirement pay.[142] The U.S. Supreme Court has held that, while the state courts cannot treat the totality of military retired pay as community property, they may treat disposable retired pay as community property.[143] However, the portion of disposable retired pay which is waived in order to receive tax-free service-related disability benefits (if the recipi-

[132] Cal. Prob. Code §66, §101, §6401; Idaho Code Ann. §15-2-201; La. Civ. Code Ann. art. 3526; Wash. Rev. Code §26.16.220–§26.16.250.

[133] Ariz. Rev. Stat. Ann. §25-318(A); Cal. Fam. Code §63, §125, §2550; La. Civ. Code Ann. art. 3526; N.M. Stat. §40-3-8(C)(1); Tex. Fam. Code Ann. §7.002.

[134] T.C. Memo 1994-421.

[135] *Dunn v. Idaho State Tax Commission*, 403 P.3d 309 (Idaho 2017) (character of husband's income, earned in Texas, determined by Texas community property law, and wife's community property interest in husband's income was subject to Idaho income tax because wife was Idaho domiciliary); *Selzer v. Sessions*, 940 P.2d 261 (Wash. 1997) (character of husband's lottery proceeds determined under Washington law, not Texas law, as husband was domiciled in Washington at time lottery tickets purchased).

[136] *See v. See*, 64 Cal.2d 778, 415 P.2d 776 (1966). See the discussion at II.C., below.

[137] See the discussion at II.C., below.

[138] *See Shanghai Commercial Bank Ltd. v. Kung Da Chang*, 404 P.3d 62 (Wash. 2017). Washington's Court of Appeals looked at the question of whether a judgment debtor's community property, located in Washington, was reachable to satisfy a Hong Kong judgment. The debtor entered into a credit arrangement with a Hong Kong bank, and ultimately defaulted. The bank obtained a judgment in Hong Kong, which was found valid in Washington. The court applied the criteria in *Erwin v. Cotter Health Ctrs., Inc.*, 167 P.3d 1112 (Wash. 2007), to determine there was an actual conflict of law where the outcomes would be different under the laws of the two jurisdictions. The court then looked at the effectiveness of the parties' choice of law under Restatement (Second) Conflict of Laws §187, and barring an application of Hong Kong law that would be contrary to Washington policy, Restatement (Second) Conflict of Laws §188. *See also Pac. Gamble Robinson Co. v. Lapp*, 622 P.2d 850 (Wash. 1980); *Potlatch No. 1 Fed. Credit Union v. Kennedy*, 459 P.2d 32 (Wash. 1969).

[139] *See, e.g., Ashabraner v. Estate of Chatelain*, Nos. B285456, B288714, 2019 BL 232453 (Cal. App. June 24, 2019), cert. denied No. S257259, 2019 BL 345412 (Sept. 11, 2019). *See also Leonard Bierman & John Hershberger, Federal Preemption of State Family Property Laws: The Marriage of McCarty and Ridgway Has Not Been Dissolved by Congress*, 9 Cmty. Prop. J. 259 (Fall 1982).

[140] 45 U.S.C. §231m. 45 U.S.C. §231m(b)(2), effective as to annuity payments made after August 12, 1983, provides that the basic rule of 45 U.S.C. §231m against assignment or attachment of benefits under the Act does not apply to that portion of an annuity (with certain stated exceptions) which qualified as community property for the purposes of distribution in accordance with a court decree of divorce, annulment, or legal separation, or the terms of any court-approved property settlement incident to any such court decree. Accordingly, the result in *Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979), might be different under the statute as presently written.

[141] *Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979) (Railroad Retirement Act).

[142] In 1982, amendments to the military pension provisions, under USFSPA, Pub. L. No. 97-252, §1002(a), found at 10 U.S.C. §1408, allowed states to treat retirement pay as either the enlisted spouse's property or as both spouse's property, under certain restrictions. *See In re Thomas*, 47 B.R. 27 (1984). Previous law had held that military retirement pay was not subject to distribution as community property on dissolution. Former 10 U.S.C. §3911 (before Uniformed Services Former Spouses' Protection Act (USFSPA), Pub. L. No. 97-252, tit. X., §1002). *See also McCarty v. McCarty*, 453 U.S. 210 (1981), was legislatively overruled by the USFSPA, 10 U.S.C. §1408(c)(1). *See Berry v. Berry*, 216 Cal. App. 3d 1155, 265 Cal. Rptr. 338 (1989); *Rohring v. Rohring*, 441 So.2d 485 (La. Ct. App. 1983); *Barros v. Barros*, 34 Wash. App. 266, 660 P.2d 770 (1983) (holding McCarty still viable on military survivor annuity benefits). The 1982 amendments do not apply to final dissolution decrees entered before June 25, 1981, which did not treat military pensions as community property. 10 U.S.C. §1408(c)(1), applicable to judgments issued before, on, or after the enactment date, November 5, 1990. This 1990 amendment was designed to help reduce the flood of cases that sought to reopen pre-McCarty divorce cases to partition military pensions. *See* Johnson v. Johnson, 605 So.2d 1157 (La. Ct. App. 1992) (cases cited therein).

[143] *Mansell v. Mansell*, 490 U.S. 581 (1989).

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ent makes the election to do so) cannot be treated as community property.[144] Although federal law preempts state courts from treating military disability benefits as community property that can be divided during divorce, it does not prevent state courts from dividing military disability benefits while enforcing indemnification provisions, as res judicata, in negotiated property settlements.[145]

Government bonds present similar problems. A number of courts have held that state law may allow the wife to recover one-half the value of a bond acquired with community property even though the husband has designated a stranger as beneficiary.[146]

The federal copyright laws have been held not to preempt state community property laws.[147] Similarly, federal legislation governing IRAs has been held not to preempt state community property laws.[148] In contrast, the Social Security Act has been held to preempt state community property laws.[149]

Courts have held that ERISA preempts state community property laws.[150] In *Ablamis v. Roper*, the Ninth Circuit held that a deceased nonemployee spouse's will does not govern disposition of one-half interest in the employee spouse's pension benefits under ERISA,[151] notwithstanding California's rejection of the "terminable interest" rule.[152] The court noted that a nonemployee spouse who predeceases the employee spouse has no power under the community property laws to make any testamentary disposition of half of the survivor's pension benefits.

Agreeing with the Ninth Circuit in a 5-4 decision, the Supreme Court in *Boggs v. Boggs*,[153] reversed the Fifth Circuit and held that ERISA preempted Louisiana community property law, so that a deceased nonemployee spouse had no community property rights in her husband's qualified plan, other than those provided by ERISA. The Ninth Circuit held that a surviving spouse's claim for half of the proceeds of life insurance provided to the deceased spouse under an ERISA benefits package were not preempted by ERISA.[154] However, this gentler position was later abrogated in a Supreme Court decision.[155]

Spouses of convicted drug traffickers are precluded by the federal criminal forfeiture statute[156] from relief as to their claim that illegal drug moneys were community property under the California community property presumption.[157]

Federal courts are not bound by a determination of a state court that affects federal estate tax liability unless the determination was by the highest court of the state.[158] A good faith settlement between a surviving spouse and the estate of a deceased spouse does not determine the character of the payment as community property for federal tax purposes.[159]

A spouse in a community property state is not entitled to a refund of her share of community property used to pay the federal income tax liability of her spouse. The Ninth Circuit and the Tax Court decided that a wife who obtained innocent spouse relief under §6015[160] was not entitled to a refund of her one-half of community property that had been used to make partial payment of the income tax that was ultimately determined to be the sole liability of her husband. Both courts determined that the federal tax statute overrode state law.[161]

J. Alaska Community Property Act

Alaska's Community Property Act[162] establishes an elective community property system, under which spouses can by mutual agreement treat all or specific assets as community property under a regime that shares elements of those in the original community property states. In the absence of such mutual agreement under the statute, common law principles would

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[144] *Howell v. Howell*, 137 S. Ct. 1400 (2017) *citing Mansell*, 490 U.S. 581.

[145] *See Martin v. Martin*, 520 P.3d 813 (Nev. 2022) (distinguishing *Howell* and *Mansell* as cases not involving parties' agreement to indemnification provision intersecting with 10 U.S.C. §1408; affirming district court's enforcement of divorcing veteran's agreement to reimburse spouse if veteran elected to receive military disability pay rather than retirement benefits) *aff'g district court and rev'g* 498 P.3d 1289 (Nev. Ct. App. 2021) (held that district court erred when it enforced reimbursement provision; disagreed that res judicata doctrine applied). *See also Mansell v. Mansell*, 490 U.S. 581 (1989) ("whether the doctrine of res judicata, as applied in [State], should have barred the reopening of … [property] settlements is a matter of state law over which we have no jurisdiction." — *footnote n.5*); *Shelton v. Shelton*, 78 P.3d 507 (Nev. 2003) (state courts may enforce divorce decrees as res judicata even if those decrees involve distributions of military disability pay).

[146] *Compare Yiatchos v. Yiatchos*, 376 U.S. 306 (1964) *with Free v. Bland*, 369 U.S. 663 (1962). For a discussion of the differences between *Yiatchos* and *Bland*, see *Estate of Tillotson*, No. 05-19-01192-CV, 2020 BL 506284, (Tex. App. Dec. 30, 2020). *See also Estate of Bray*, 230 Cal. App. 2d 136, 40 Cal. Rptr. 750 (1964); *In re Succession of Guerre*, 197 So.2d 738 (La. Ct. App. 1967). *But see In re Succession of Harrell*, 622 So.2d 253 (La. Ct. App. 1993) (survivorship provisions applicable to co-owners of U.S. savings bonds preempt state community property law).

[147] *Worth v. Worth*, 195 Cal. App. 3d 768, 241 Cal Rptr. 135 (1987); *Rodrigue v. Rodrigue*, 218 F.3d 432 (5th Cir. 2000) (La.).

[148] *United States v. Berry*, No. 17-385, 2018 BL 466921 (S.D. Tex. Dec. 17, 2018), *aff'd*, 951 F.3d 632 (5th Cir. 2020); *Mundell v. Mundell*, 124 Idaho 152, 857 P.2d 631 (1993); *Estate of Tillotson*, No. 05-19-01192-CV, 2020 BL 506284, (Tex. App. Dec. 30, 2020) (applies to IRA and Roth IRA); PLR 201623001 (community property interest in inherited individual retirement account (IRA) is matter of state property law and disregarded under §408), PLR 199937055 (classification of IRA as community property determined under state law).

[149] *Bowlden v. Bowlden*, 118 Idaho 89, 794 P.2d 1145 (Ct. App. 1989).

[150] *See e.g.*, *Ashabraner v. Estate of Chatelain*, Nos. B285456, B288714, 2019 BL 232453 (Cal. App. June 24, 2019), cert. denied No. S257259, 2019 BL 345412 (Sept. 11, 2019) (ERISA preempts "any and all state laws insofar as they may now or hereafter related to any employee benefit plan covered by ERISA"); *Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991); *Meek v. Tullis*, 791 F. Supp. 154 (W.D. La. 1992).

[151] 937 F.2d 1450 (9th Cir. 1991). *Ablamis* was followed in *Meek v. Tullis*, 791 F. Supp. 154 (W.D. La. 1992) (intestate succession). *See also Owens v. Automotive Machinists Pension Tr.*, 551 F.3d 1138 (9th Cir. 2009). In *Mundell v. Mundell*, 124 Idaho 152, 857 P.2d 631 (1993), the court found that the federal law relating to IRAs had not preempted state law. Before *Ablamis*, several state courts had held that aspects of ERISA did not preempt state community property laws. *In re Succession of Netterville*, 579 So.2d 1046 (La. Ct. App. 1991); *In re Marriage of Baker*, 204 Cal. App. 3d 206, 251 Cal. Rptr. 126 (1988). For a discussion of distributions from qualified plans, see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification* (U.S. Income Series).

[152] See the discussion of the terminable interest rule at II.C.6., above.

[153] 520 U.S. 833 (1997).

[154] *Emard v. Hughes Aircraft Co.*, 153 F.3d 949 (9th Cir. 1998).

[155] *Egelhoff v. Egelhoff*, 532 U.S. 141 (2001).

[156] 21 U.S.C. §853.

[157] *United States v. Hooper*, 229 F.3d 818 (9th Cir. 2000).

[158] *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

[159] *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981).

[160] All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise indicated.

[161] *Ordlock v. Commissioner*, 533 F.3d 1136 (9th Cir. 2008), aff'g 126 T.C. 47 (2006). For a detailed discussion of innocent spouse relief, see 645 T.M., *Innocent Spouse Relief* (U.S. Income Series).

[162] Alaska Stat. §34.77.

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continue to be applied as to property owned by either or both spouses in Alaska.

Under the Alaska statute, if a community property agreement provides that all property acquired by either or both of the spouses during marriage is community property, then there is a presumption that property acquired by the spouses during the marriage (and after the "determination date," defined as the later of: (1) the marriage; (2) the effective date of the community property agreement or a community property trust; or (3) May 23, 1998) is community property.[163] Similarly, in the presence of such a community property agreement, all income earned or accrued by either spouse or attributable to the property of either spouse during the marriage and after the determination date is community property.[164] Community property transferred to a trust remains community property.[165] Property owned by either spouse prior to the determination date is, in general, not community property, unless the agreement otherwise provides.[166] Again, unless the agreement otherwise provides, property acquired during marriage and after the determination date is "individual property" (corresponding to "separate property"), if it is acquired: (1) by gift or bequest; (2) in exchange for, or with the proceeds of, the spouse's other individual property; or (3) from appreciation or income of the spouse's individual property, among other enumerated circumstances.[167] Appreciation and income of property transferred to a community property trust is community property if declared so in the trust.[168]

Management and control of the elective community property is conferred upon one spouse, acting alone, for: (1) community property held in that spouse's name alone (or not held in the name of either spouse); (2) an insurance policy if that spouse is designated is owner on the issuer's records; (3) an employee's rights under a deferred compensation plan; and (4) community property held in an "either/or" account.[169] One spouse acting alone may not make gifts to a third party of community property which that spouse has the right to manage and control, unless the value given does not aggregate to more than $1,000 in a calendar year, "or a larger amount if, when made, the gift is reasonable in amount considering the economic position of the spouses."[170]

An interesting feature of the Alaska statute is the ability for non-Alaskans to hold assets in Alaska community property trusts, with the expectation that they will enjoy the advantages of community property law, including the double step-up in basis under §1014 at the death of the first spouse.

Practice Tip: This creates an opportunity for planners with clients outside Alaska, including those residing in non-community property states, Non-Alaskans must generally appoint an Alaskan trust company or an Alaskan bank as trustee, but non-Alaskans can also serve as co-trustees so long as at least one trustee is such a "qualified person."[171]

[163] Alaska Stat. §34.77.030(b).
[164] Alaska Stat. §34.77.030(d).
[165] Alaska Stat. §34.77.030(e).
[166] Alaska Stat. §34.77.030(f).
[167] Alaska Stat. §34.77.030(g).
[168] Alaska Stat. §34.77.030(h).
[169] Alaska Stat. §34.77.040(a).
[170] Alaska Stat. §34.77.050(a).
[171] Alaska Stat. §34.77.100(a)(2), §34.77.100(a)(3).

The specific terms and provisions that are to be covered in a community property agreement and a community property trust are set forth in the statute.[172] Perhaps in light of the frequent litigation in other community property jurisdictions relating to the rights of the respective spouses and their heirs in the proceeds of life insurance policies, and to give some comfort to insurers, the Alaska statute provides detailed provisions for the classification of life insurance policies and proceeds.[173] The statute also provides for the division of community property at death.[174]

Practice Tip: It is worth noting that the IRS continues to decline to comment on whether property classified as community property under the Alaska statute or similar elective community property legislation is entitled to the step up in basis.[175]

K. Tennessee Community Property Trust Act

Following Alaska's lead, in 2010 the Tennessee legislature enacted the Tennessee Community Property Act, allowing spouses to create, whether or not domiciled in Tennessee,[176] "community property trusts."[177] All property owned by the community trust constitutes community property during the marriage.[178] The instrument must expressly declare that the trust is a Tennessee community property trust.[179] The trust must have at least one qualified trustee,[180] and either or both spouses may serve as trustee if the qualifications are met.[181] Both spouses must sign the instrument,[182] and it must contain a prescribed warning provision in capital letters.[183]

The agreement establishing the community property trust may provide for the rights and obligations in the property transferred to the trust; the management and control of the property transferred to the trust; the disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event; the choice of law governing the interpretation of the trust; and any other matter that affects

[172] Alaska Stat. §34.77.090, §34.77.100.
[173] Alaska Stat. §34.77.120.
[174] Alaska Stat. §34.77.155.
[175] IRS Pub. 555, *Community Property*, 1, 2 ("This publication doesn't address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws."). See also IRM 25.15.5 Relief from Community Property Laws (04-14-2020) ("The U.S. Supreme Court ruled that the Oklahoma statute would not be recognized for federal income tax reporting purposes. Commissioner v. Harmon, 323 U.S. 44 (1944). The Harmon decision should also apply to the Alaska system for income tax purposes.").
[176] Tenn. Code Ann. §35-17-105(a).
[177] Tenn. Code Ann. §35-17-103.
[178] Tenn. Code Ann. §35-17-105(c).
[179] Tenn. Code Ann. §35-17-103(1).
[180] Tenn. Code Ann. §35-17-102(6) defines a "qualified trustee" for these purposes as either a natural person who is a resident of Tennessee or a company authorized to act as a fiduciary in Tennessee.
[181] Tenn. Code Ann. §35-17-103(2).
[182] Tenn. Code Ann. §35-17-103(3).
[183] Tenn. Code Ann. §35-17-104(4) requires the following language:

> THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.

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the property transferred to the trust which does not violate public policy or a statute imposing a criminal penalty.[184] Either spouse may amend the trust regarding his or her respective community one-half share of the trust property, or regarding the disposition of that share upon the amending spouse's death;[185] otherwise, the trust may not be revoked or amended unless the instrument provides for amendment or revocation.[186]

A Tennessee community property trust is enforceable without consideration.[187] The trust terms determine the right to manage and control the trust property.[188] Property distributed from the trust no longer constitutes community property.[189] The obligation of one spouse incurred before or during the marriage may be satisfied from that spouse's one-half share of the trust;[190] obligations incurred by both spouses during the marriage may be satisfied from the trust.[191] Upon a spouse's death, half of the aggregate value of the trust property reflects the deceased spouse's share and the other half the surviving spouse's share.[192] In the case of a dissolution of marriage, the trust terminates and the trustee distributes half of the assets to each spouse, unless otherwise agreed in writing by both spouses.[193]

Practice Tip: It has been suggested that the Tennessee Community Property Trust Act, designed to provide a community property "double stepped-up basis," may not fulfill all of its promise. The concerns expressed by one commentator include the uncertainty of whether the Tennessee community property trust will be afforded such tax treatment, and that creating such a trust can potentially forfeit valuable creditor protection benefits.[194]

L. South Dakota Special Spousal Trust

South Dakota followed suit and enacted legislation authorizing "Special Spousal Trusts" and classifying property in such trusts as community property eligible for the double step up in basis under §1014(b)(6).[195] The South Dakota legislation is very similar to Tennessee's structure: a trust is required, the special spousal trust can be created by nonresidents of South Dakota and at least one trustee must be a South Dakota resident or corporate trustee.[196] Creditor rights in property are not affected by transfer into a special spousal trust unless the trust also qualifies as a domestic asset protection trust under South Dakota law.[197] It therefore appears that South Dakota community property does not give creditor access similar to that under the systems in place in the traditional community property states. It also does not appear that property that is distributed out of a special spousal trust retains community property characterization unless the property had been characterized as community property under another state's laws.[198]

Practice Tip: The availability of the double step up in basis for property in a South Dakota special spousal trust has not been confirmed.[199]

M. Kentucky Community Property Trust Act

In 2020, Kentucky enacted an opt-in community property scheme.[200] It follows the Tennessee and South Dakota model and requires that the spouses place property into a "community property trust."[201] The trustors need not be residents of Kentucky, but at least one trustee must be a resident of Kentucky or a corporate trustee authorized to act as trustee in Kentucky.[202] Property distributed from the trust is no longer considered community property.[203] Creditors of one spouse can only access that spouse's one-half of the trust property,[204] and management of the property in the trust is determined by agreement of the spouses in the trust agreement.[205]

Practice Tip: The availability of the double step up in basis for property in a Kentucky community property trust has not been confirmed.[206]

N. Florida Community Property Trust Act

Florida adopted the Florida Community Property Trust Act in 2021.[207] The Florida statute appears to follow the model of the other states with community property trust statutes, and has a specific provision that homestead property transferred into a community property trust retains that classification.[208]

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[184] Tenn. Code Ann. §35-17-104(a).
[185] Tenn. Code Ann. §35-17-104(b)(1).
[186] Tenn. Code Ann. §35-17-104(b)(2).
[187] Tenn. Code Ann. §35-17-105(b).
[188] Tenn. Code Ann. §35-17-105(d).
[189] Tenn. Code Ann. §35-17-105(e).
[190] Tenn. Code Ann. §35-17-106(a).
[191] Tenn. Code Ann. §35-17-106(b).
[192] Tenn. Code Ann. §35-17-107.
[193] Tenn. Code Ann. §35-17-108.
[194] William C. Roberts *A Cautionary Tale: Community Property Trusts*, Tenn. Bar Ass'n (Sept. 6, 2011), at http://www.tba.org/journal/archive/2011-07; *see* IRS Pub. 555, *Community Property*, at 1, 2 ("This publication doesn't address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws.").
[195] S.D. Codified Laws Ann. §55-17-5.
[196] Terry Prendergast, *South Dakota Special Spousal Property Trusts: South Dakota "Steps-up" to the Plate and Hits a Home Run for Surviving Spouses*, 61 S.D. L. Rev. 431 (2016).
[197] S.D. Codified Laws Ann. §55-17-11. For a further discussion of a South Dakota asset protection trust, see 868 T.M., *Domestic Asset Protection Trusts.*
[198] *See* S.D. Codified Laws Ann. §55-17-5.
[199] *See* IRS Pub. 555, *Community Property*, at 1, 2 ("This publication doesn't address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws.").
[200] Kentucky Community Property Trust Act, 2020 Ky. H.B. 155.
[201] Ky. Rev. Stat. Ann. §386.620.
[202] Ky. Rev. Stat. Ann.§386.620–§386.622.
[203] Ky. Rev. Stat. Ann. §386.622(8).
[204] Ky. Rev. Stat. Ann. §386.624.
[205] Ky. Rev. Stat. Ann. §386.622(2).
[206] *See* IRS Pub. 555, *Community Property*, at 1, 2 ("This publication doesn't address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws.").
[207] Fl. Stat.§ 736.1501–§736.1512.
[208] Fl. Stat. §737.1510.

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III. Income Taxation of Community Property

A. Importance in Estate Planning

In planning for an estate involving community property, it is important for the planner to know how the income from community property will be taxed both before and after death. The possibility of shifting income among different taxpayers with varying tax brackets is somewhat more complicated when community property is involved. The following discussion covers income tax issues specific to community property that may arise during a marriage and income tax issues when a married person owning community property dies.

B. Basic Concepts of Income Taxation of Community Property

In *Poe v. Seaborn*,[209] the U.S. Supreme Court acknowledged that a married couple's community property income is attributable one-half to each spouse for purposes of the federal income tax. Income from property placed in community property trusts under the laws of Alaska, Tennessee, South Dakota, Kentucky, Florida, and any other state with similar laws is apparently not considered community property by the IRS.[210]

If the spouses live in different states, then their respective earnings will likely be characterized by the state of residence of the earning spouse.[211] This may be significant for state income tax purposes.

> *Example:* Spouse A lives and works in Washington. Spouse B lives and works in Oregon. One-half of Spouse A's income will be attributable to Spouse B and subject to Oregon income tax, whereas Spouse B's income will be entirely attributable to Spouse B and also subject to Oregon income tax. Washington has no income tax, but only one-half of Spouse A's earnings will benefit from that.[212]

If one of the spouses is a nonresident alien, then the spouses must file separate income tax returns and the earnings of each spouse are attributable entirely to the earner, even if the earnings are community property under local law.[213]

Practice Tip: If spouses live in different states and one spouse lives in a community property state, the spouses should consider an agreement that designates the community property spouse's income as his or her separate property, in order to avoid subjecting one-half of the income to the income tax of the other spouse's resident state. Planning would, of course, take into consideration the income tax system of each of the states.

C. Effect of Transmutation Agreements for Income Tax Purposes

In *Commissioner v. Harmon*,[214] the U.S. Supreme Court considered the effect of an Oklahoma statute that created an elective community property system, allowing spouses to opt into community property if they wanted to split their income between the spouses. The Court ruled that the Oklahoma statute created a consensual rather than legal community and therefore, under *Lucas v. Earl*,[215] the community ownership would not be recognized for federal income tax purposes. The IRS has confirmed, however, that in a community property state, if a married couple converts community property to separate property or, vice versa, by an agreements recognized under state law, then such conversions will be recognized for federal income tax purposes. However, if the agreement only converts income from separate property to community property, and does not convert the underlying separate property itself to community property, "the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns."[216]

D. Income Taxation of Community Earnings upon Separation

Upon separation but before a marriage is legally dissolved, each spouse may be liable for income tax on one-half of the other spouse's earnings. A separated spouse may be eligible for some relief, however, under federal income tax law or state law under certain circumstances.

1. Section 66(a)

Under §66(a), a separated spouse can be relieved of federal income tax liability on community income earned by the other spouse. If the requirements of §66(a) are satisfied, the community property laws regarding the taxation of such income are disregarded and the spouse who earned the income is liable for the federal income tax for this community income. In order for §66(a) to apply for a given calendar year, the individuals must: (1) be married at some time during the calendar year, (2) live apart at all times during the calendar year, and (3) not file a joint return for a taxable year beginning or ending during such calendar year. In addition, §66(a)(3) and §66(a)(4) provide that one or both of the individuals must have earned income for the calendar year which is community income and no portion of that earned income was transferred to the other spouse.[217]

2. Section 66(c)

In situations in which the spouses have not lived apart the entire calendar year — thus making §66(a) inapplicable by virtue of §66(a)(2)(A)[218] — relief may still be available under §66(c). Section 66(c) applies to situations in which a spouse fails to include in gross income an item of community proper-

[209] 282 U.S. 101 (1930).

[210] IRM 25.15.5 Relief from Community Property Laws (04-14-2020) ("The U.S. Supreme Court ruled that the Oklahoma statute would not be recognized for federal income tax reporting purposes. *Commissioner v. Harmon*, 323 U.S. 44 (1944). The Harmon decision should also apply to the Alaska system for income tax purposes.").

[211] *See Dunn v. Idaho State Tax Commission*, 403 P.3d 309 (Idaho 2017) (character of husband's income, earned in Texas, determined by Texas community property law, and wife's community property interest in husband's income was subject to Idaho income tax because wife was Idaho domiciliary).

[212] *See Keller v. Or. Dept. of Revenue*, 642 P.2d 284 (Or. 1982).

[213] §6013(a)(1); *see also* §879.

[214] 323 U.S. 44 (1944).

[215] 281 U.S. 111 (1930).

[216] Rev. Rul. 77-359 (Washington) (citing *Commissioner v. Harmon*, 323 U.S. 44).

[217] For purposes of §66(a), "earned income" is defined as set forth in §911(d)(2). §66(d).

[218] *See Warner v. Commissioner*, T.C. Memo 1987-219.

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ty income that would be treated as the income of the earning spouse under the §879(a) rules. Under §66(c), the IRS may relieve a spouse's liability if, taking in to account all the facts and circumstances, it would be inequitable to hold the non-earning spouse liable for any unpaid tax or deficiency.[219] A spouse seeking equitable relief from the operation of community property law under §66(c) must meet the following five criteria set forth in Rev. Proc. 2013-34:[220]

- application for relief must be made within the period of limitations on collection (generally 10 years) or if a credit or refund is sought, within the period of limitations on credits or refunds (generally two or three years);
- no assets were transferred between the individuals filing the joint return as part of a fraudulent scheme;
- there were no disqualified assets transferred to the individual by the nonrequesting spouse;[221]
- the requesting spouse did not knowingly participate in the filing of a fraudulent joint return; and
- the income tax liability generally is attributable (in full or in part) to an income item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income (generally, if the liability is partially attributable to the requesting spouse, relief is only available for the portion attributable to the nonrequesting spouse).

The requesting spouse does not need to establish that lack-of-knowledge or separate return relief is not available.

Further, the requesting spouse may be eligible for a streamlined determination for equitable relief if:[222]

- the requesting spouse filed a joint return, or a separate return in a community property state;
- he or she is no longer married to the nonrequesting spouse;
- failure to grant relief would result in economic hardship; and
- he or she did not know or have reason to know that there was an understatement or deficiency on the joint return, or did not know or have reason to know that the nonrequesting spouse would not or could not pay the understatement. This factor is satisfied if the requesting spouse was abused or the nonrequesting spouse maintained control over the household finances by restricting the requesting spouse's access to financial information, and the requesting spouse feared questioning items on the return or payment of the liability for fear of retaliation.[223]

A requesting spouse seeking equitable relief under §66(c) must file Form 8857, *Request for Innocent Spouse Relief (and Separation of Liability, and Equitable Relief)*, or other similar statement signed under penalties of perjury, within the applicable period of limitation.[224]

For a case involving the operating of these §66 principles, see *Corrino v. Commissioner*.[225] There, the Tax Court ruled that income from a partnership created by husband was attributable to wife under §66, as they were legally married, although legally separated, at the time husband invested in the partnership, and accordingly, community funds were used to make the investment.

3. *Washington and California*

In Washington and California, a separated spouse may be relieved from income tax liability for the other spouse's earnings immediately upon separation. These states each provide that once the couple separates and the marriage is defunct, each spouse's earnings are their separate property, and community property ceases to accrue.[226]

E. *Income Tax Return for Year of Death of First Spouse to Die*

1. *Return*

Income received by a decedent in the year of death but prior to death, may be reported on a separate individual income tax return for the year of death. Such a return would reflect the decedent's one-half share of community income received from the beginning of the year to the date of death, as well as all income from the decedent's separate property received during this period. Similarly, the surviving spouse could file a separate return for that year, which would include all of the following: (1) his or her one-half of the community income received from the beginning of the year to the date of the deceased spouse's death; (2) his or her half of the community income received from the date of death to the end of the year; and (3) and his or her separate income for the entire year.

[219] §66(c); Reg. §1.66-1 through §1.66-5. Proposed regulations would move the regulation's effective dates from Reg. §1.66-5 to each regulation. *See* Prop. Reg. §1.66-1 through §1.66-4; REG-134219-08, 80 Fed. Reg. 72,649 (Nov. 20, 2015) (applicable on date final regulations are published).

[220] Section 4.01, effective for requests for relief filed on or after September 16, 2013 and for requests pending on that date. For the revenue procedure initially proposed by the IRS, see Notice 2012-8. Rev. Proc. 2013-34 and Notice 2012-8 *supersede* Rev. Proc. 2003-61.

[221] §6015(c)(4)(B). If any such assets were transferred, the individual may still seek relief to the extent that the liability exceeds the value of those disqualified assets. However, if the requesting spouse was abused or the nonrequesting spouse maintained control over the household finances by restricting the requesting spouse's access to financial information, the requesting spouse may still be eligible for relief. Additionally, the requesting spouse may still be eligible if he or she did not have actual knowledge that disqualified assets were transferred.

[222] Rev. Proc. 2013-34, §4.02. *See Corbisiero v. Commissioner*, T.C. Summ. Op. 2014-42 (requesting spouse met all three requirements).

[223] These relief rules as applicable to community property context are summarized and discussed in IRM 25.15.5.1 (07-24-2017)–25.15.5.19 (07-24-2017). *See* Additional Resources, Uniform Disposition of Community Property Rights at Death Act, below.

[224] Two years from the date of the first collection activity against the requesting spouse. §6015(b)(1)(E); Reg. §1.6015-5(b)(1); Prop. Reg. §1.6015-5(b)(1), REG-132251-11, 78 Fed. Reg. 49242 (Sept. 13, 2013), effective for requests for relief filed on or after July 25, 2011. Prop. Reg. §1.6015-9. For further discussion on innocent spouse relief, see 645 T.M., *Innocent Spouse Relief* (U.S. Income Series).

[225] T.C. Memo 2014-34 (2014). The Tax Court noted, at n. 21, that §66(b) authorizes the Commissioner to disallow the benefits of any community property law to a taxpayer for any income, if: (i) the taxpayer acted as if he were solely entitled to such income, and (ii) the taxpayer failed to notify his spouse of the nature and amount of such income before the due date for filing the return for the tax year in which the income was derived.

[226] Cal. Fam. Code §771(a); Wash. Rev. Code §26.16.140.

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In the alternative, the decedent's income can be reported on a joint return filed with the surviving spouse[227] for the year of death, under §6013. The combined income of the spouses will be taxable at a lower marginal rate if a joint return is filed.

Pursuant to §6013(a)(3) and Reg. §1.6013-1(d)(3), the joint return is ordinarily filed by the decedent's executor. A joint return may not be filed if the surviving spouse remarries before the close of the taxable year in which the death occurred.[228] Unless he or she is acting as executor, the surviving spouse may file a joint return only if the §6013 requirements are satisfied.[229]

2. *Gross Income: Joint Return*

A joint income tax return for the decedent and surviving spouse for the taxable year in which the decedent died includes:

- income from the decedent's separate property received from the beginning of the taxable year to the date of death;
- all community property income received from the beginning of the taxable year to the date of death;
- the surviving spouse's half of the community income received from the date of death to the end of the taxable year;[230]
- income from the separate property of the surviving spouse for the entire taxable year; and
- income from the decedent's separate assets and his or her interest in community assets which passed to the surviving spouse by survivorship (e.g., nontestamentary assets such as life insurance, joint tenancy property, and U.S. savings bonds).

In addition, if the personal representative makes distributions to the surviving spouse, and the estate's taxable year ends before or on the same date as the taxable year of the surviving spouse, then some distributable net income from the estate may also be included in the joint return.[231]

Income received during the decedent's year of death may be demonstrated as follows, assuming a date of death of May 5:

[227] Half the community income earned between the date of death and closing of administration is reportable by the estate and half by the surviving spouse. Rev. Rul. 55-726 (Washington, California, and "all community property states having similar community property laws"). *See Grimm v. Commissioner*, 89 T.C. 747 (1987), *aff'd*, 894 F.2d 1165 (10th Cir. 1990) (Philippines); *Petersen v. Commissioner*, 35 T.C. 962 (1961) (Cal. law); *Wells Fargo Bank & Union Tr. Co. v. United States*, 245 F.2d 524 (9th Cir. 1957) (Cal. law); *Sneed v. Commissioner*, 220 F.2d 313 (5th Cir. 1955) (Tex. law); *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954) (Wash. law).

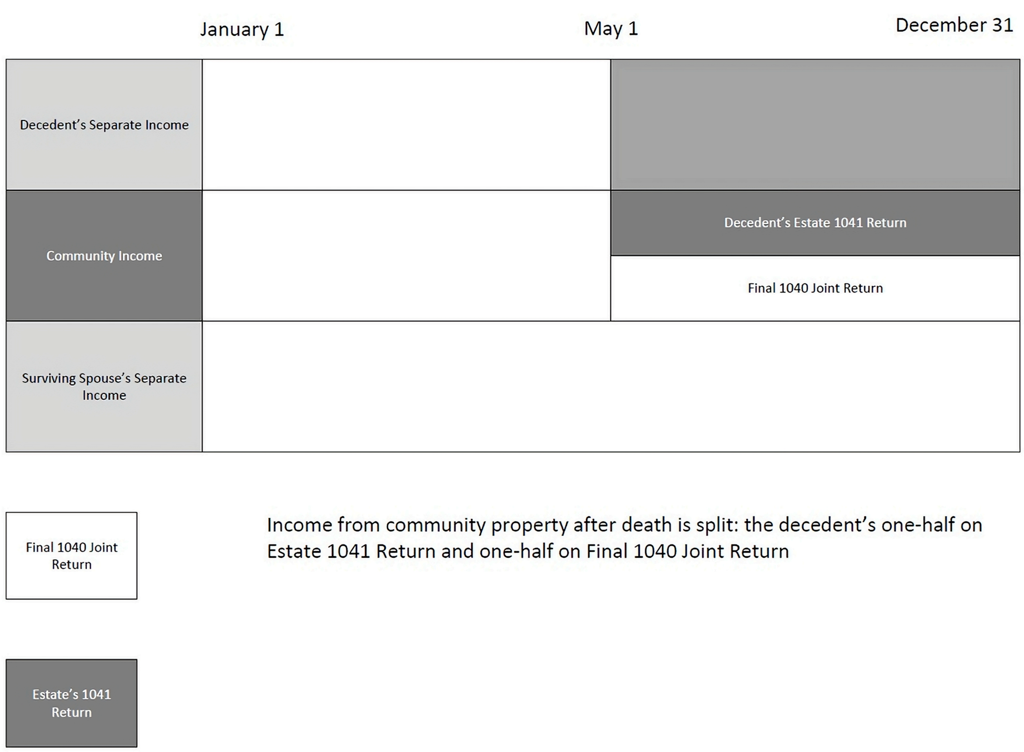
[228] §6013(a)(2); Reg. §1.6013-1(d)(2). The spouses' taxable years must begin on the same day. §6013(a)(2); Reg. §1.6013-1(d)(1). No joint return is permitted if either spouse was a nonresident alien at any time during the taxable year. §6013(a)(1); Reg. §1.6013-1(b).

[229] The surviving spouse may not file a joint return unless the following circumstances exist: (i) the decedent has not filed a separate return for the taxable year in which the death occurred; and (ii) no executor or administrator can have been appointed before the surviving spouse files the joint return, nor before "the last day prescribed by law for filing the return of the surviving spouse." §6013(a)(3); Reg. §1.6013-1(d)(3)(i), §1.6013-1(d)(3)(ii), §1.6013-1(d)(3)(iii). The executor or administrator may disaffirm the surviving spouse's joint return by filing a separate return for the decedent within one year after the last day prescribed for filing the surviving spouse's return. *See* Reg. §1.6013-1(d)(5). The executor or administrator, however, is not permitted to disaffirm certain joint returns filed by the surviving spouse prior to the decedent's death. CCA 201830012 (where wife filed amended returns prior to death of husband, §6013(a)(3) was inapplicable and, therefore, executrix could not disaffirm amended returns because wife was not surviving spouse (as defined under §2(a)) upon filing such returns).

[230] *See* Rev. Rul. 55-726; *see* III.E.1., above.

[231] §691.

Source of Income



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The income in the unshaded area is included in the joint return for the taxable year in which the decedent died.[232]

3. Deductions

Each expense that is a potential deduction against income tax on the decedent's and surviving spouse's returns must be separately analyzed based on the date the expense was paid, the source of funds used to pay the expense, and the nature of the expense.

a. Medical Expenses

Medical expenses incurred and paid prior to the date of death are deductible on the joint return, as are medical expenses of the surviving spouse incurred subsequent to the deceased spouse's date of death. Medical expenses of the decedent incurred prior to the date of death and paid by the personal representative within one year after the date of death may be claimed as deductions either on the federal estate tax return or on the estate's income tax return for the year in which they were incurred.[233] The obligation to pay medical expenses usually must be satisfied out of community funds.

Practice Tip: If the estate pays the decedent's medical expense, more satisfactory results are generally obtained if the deduction is taken on the income tax return for the year the expense was incurred, provided the expenses exceed 10% of the adjusted gross income.[234] In contrast, if the deduction is claimed on the federal estate tax return,[235] then only half of the deduction — the half of the debt owing at the date of death which is attributable to the decedent — may be taken on Form 706, Schedule K. The deductibility of the other half, which is payable from the surviving spouse's half of the community property, may be lost if the surviving spouse pays the expense during the taxable year following the year in which the decedent died, if such expense, when combined with the surviving spouse's medical expenses in that year, do not exceed the 10% minimum. If the surviving spouse pays the debt from the surviving spouse's half of the community property in the year of death, full advantage of the deduction may still be available.

Funeral expenses are not deductible on the joint return, the surviving spouse's return if filing separately, or the estate's income tax returns for periods of administration. Funeral expenses may be deducted in the federal estate tax return.[236]

b. Contributions, Taxes, and Other Deductible Expenses

Generally, all deductible items paid by either or both spouses from the beginning of the taxable year to the date of death, and those paid by the surviving spouse from the date of death to the end of the decedent's final taxable year, will be deductible on the joint return. It will be necessary to identify those items paid with the decedent's separate funds and those paid with community funds, to determine the portion of the joint income tax attributable to the decedent.

[232] *See* Rev. Rul. 92-37.
[233] §213(c), §642(g), §2053.
[234] *See* §213.
[235] §2053(a).
[236] §2053(a)(1); *see also* 822 T.M., *Estate, Gift, and Generation-Skipping Transfer Tax Returns and Audits.*

4. Portion of Joint Tax Liability Attributable to Decedent

The income tax liability for the year of the decedent's death may constitute a debt of his or her estate. Conversely, income tax paid before death, in the form of withholding or estimated quarterly payments, which exceed the actual tax liability, may constitute an asset of the decedent's estate. Thus, after computing the joint tax liability, it is necessary to determine the portion of the liability attributable to the surviving spouse. According to the regulations,[237] in the absence of evidence to the contrary, the deductible amount is presumed to be an amount with the same ratio to the total joint tax amount for the period covered by the return as the amount of income tax for which the decedent would have been liable (had he or she filed a separate return for that period) has to the total amount of tax borne by the decedent and surviving spouse, where both filed separately. The amount attributable to the decedent can be illustrated as follows:

$$\text{deductible amount} = \left(\frac{\text{decedent's tax on separate return}}{\left(\begin{array}{c}\text{decedent's tax on separate return} \\ + \\ \text{spouse's tax on separate return}\end{array} \right)} \right) \times \text{tax on joint return}$$

5. Withholding; Estimated Payments

Income tax withholding, as well as quarterly payments on estimated tax, are eventually applied against the income tax liability of the spouses. The sources of withheld amounts and of quarterly payments must be ascertained in order to determine the portion of total tax payments attributable to the decedent and that attributable to the surviving spouse. If all of the couple's property was community property, then all withholding and quarterly payments made prior to death will be attributed one-half to each spouse. The tax character of payments made after death will depend upon whether the payments were made by the surviving spouse from his or her own property. If the payments were from the separate property of the surviving spouse, then the payments will be attributed entirely to the sur-

[237] Reg. §20.2053-6(f). There had been extensive litigation regarding whether community income received by the executor or personal representative of a deceased spouse is taxed entirely to the estate or whether half is taxable to the surviving spouse. In *Grimm v. Commissioner*, 89 T.C. 747 (1987) aff'd, 894 F.2d 1165 (10th Cir. 1990), the Tax Court reviewed the cases on this issue in the Ninth and Fifth Circuits. These decisions tend to tax the surviving spouse on half the income during the period of the estate's administration, in spite of some contrary earlier decisions taxing the estate on the entire income. In *Grimm*, the decedent husband died domiciled in the Philippines, which adopts the "conjugal partnership" theory, analogous to community property. The surviving widow subsequently moved to Utah. The estate received income, half of which the IRS argued should have been reported by the estate and half by the widow. The Tax Court, influenced by the Ninth Circuit decisions, upheld the deficiency against the widow holding that the wife owned half the installment payments before the decedent's death. It stated that the death of her husband did not diminish her interest in the payments due to the "conjugal partnership." Rather, the court explained, through his death, the husband relinquished the management powers he had over her half of the community income and the petitioner acquired those powers. Thus, the Tax Court concluded that the petitioner's interest in half the payments received after her husband's death vested immediately in her, free for disposal as she wished, subject only to the outstanding community debts.

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viving spouse. If the payments were made from estate assets, then such payments could be from either community property or the decedent's separate property. The foregoing is illustrated as follows:

Date	Source of Tax Payment	Allocation of Payment	
		S1	S2
1-31	S1's salary withholding	$ 150	$ 150
2-28	S1's salary withholding	150	150
3-31	S1's salary withholding	150	150
4-15	Quarterly payment from community checking account	500	500
4-30	S1's salary withholding	150	150
5-15	[S1's death]		
5-31	Final salary check — withholding	150	150
7-15	Quarterly payment by executor from community (non-survivorship) bank account	500	500
9-15	Quarterly payment by S2 from insurance proceeds		1,000
11-16	S2's salary withholding		50
12-1	S2's salary withholding		50
12-16	S2's salary withholding		50
1-1	S2's salary withholding		50
		$1,750	$2,950

These amounts are then applied to the joint tax liability to determine whether an overpayment or underpayment has been made with regard to either the decedent or the surviving spouse.

6. Surviving Spouse's Return

In an estate with community property, the surviving spouse's income tax return will not be significantly different from the return in a common law or separate property estate. Gross income will include:

- all income from the surviving spouse's employment (including any executor's fee);
- income from the separate property of the surviving spouse;
- income from assets which passed to the surviving spouse by survivorship or joint tenancy;
- distributable net income from the estate; and
- half of the income from community property being administered by the decedent's personal representative.[238]

One important difference exists for deductions, however. If a portion of the expenses of administration is attributable to the surviving spouse (as is the case if the probate estate must administer both halves of the property), then such portion will not be deductible on either the federal estate tax return or the estate's income tax return. Instead, that portion may be deducted by the surviving spouse on his or her income tax return for the period in which payment of the expense is made.[239]

F. *Stepped-Up Basis for Community Property upon Death of First Spouse to Die*

1. Generally — Step-Up in Basis for Surviving Spouse's One-Half Share of Community Property

Section 1014 provides that the income tax basis of the person acquiring the property from a decedent, or to whom the property passed from a decedent, is generally the fair market value of the property at the date of the decedent's death.[240] For a married couple with community property, both the decedent's and the surviving spouse's one-half interests in community property receive a new basis, if at least half of the community property was includible in the decedent's gross estate.[241]

[238] *See Grimm v. Commissioner*, 894 F.2d 1165 (10th Cir. 1990), *aff'g* 89 T.C. 747 (1987). The Tenth Circuit, in agreement with the Fifth and Ninth Circuits, held that the surviving spouse was taxable on income from her share of community property, in this case installment payments, that was paid to her as executor of the decedent's estate because her share of the property was subject to administration merely to satisfy any community debts. *See also United States v. Stonehill*, 702 F.2d 1288 (9th Cir. 1983); *Sneed v. Commissioner*, 220 F.2d 313 (5th Cir. 1955); *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954); *Henderson's Estate v. Commissioner*, 155 F.2d 310 (5th Cir. 1946).

[239] Rev. Rul. 55-524.

[240] §1014(a)(1). In calculating cost depletion for community property of the surviving spouse, the stepped-up basis is determined at the close of the taxable year of that spouse. Rev. Rul. 92-37; TAM 9042002. *See also* §1014(f) (requiring that basis not exceed value of property as finally determined for estate tax purposes); Reg. §1.1014-10, T.D. 9991, 89 Fed. Reg. 76,356 (Sept. 17, 2024).

[241] §1014(b)(6); Reg. §1.1014-2(a)(5). It is important to note that the consistent basis reporting requirements under §6035 may apply to decedent's share of community property but does not apply to the surviving spouse's interest in the community property where such interest is not included in decedent's gross estate. Reg. §1.1014-10(c)(2)(xii), §1.1014-10(c)(2)(xiii), T.D. 9991, 89 Fed. Reg. 76,356 (Sept. 17, 2024). *See* PLR 201751001, PLR 201751002, and PLR 201751003 (community property held in trust will receive full step-up in basis upon death of first grantor where grantors contributed property to trust and retained reversionary interests in trust, which resulted in incomplete gifts to trust and will result in inclusion of each grantor's community property interest in their respective estate), PLR 201550012–PLR 201550005 (basis of all community property in irrevocable trust will receive basis step-up under §1014(b)(6) at death of first spouse to die where couple reside in community property state, spouses each retain testamentary power of appointment, thus including each grantor's trust interest in his or her estate for estate tax purposes, trust instrument states all distributions before death of first spouse to die will be from community property and equally from each spouse, and assuming that distribution committee exists at death of first spouse to die to ensure trust is not grantor trust as to either spouse), PLR 9829025 (like-kind exchange of community property, completed after owner's death, did not generate income in respect of a decedent (IRD) and surviving spouse was entitled to basis step-up under §1014(b)(6)). *But cf.* PLR 200345026 (in community property state, where beneficiary wife predeceased annuitant husband, deferred variable annuity contract is annuity described in §72 and §1014(b)(9)(A); therefore, wife's one-half interest in contract was not entitled to stepped-up basis under §1014(a) and husband's one-half interest in contract was not entitled to stepped-up basis under §1014(b)(6)). For special rules applicable to the surviving spouse's interest in community property of a decedent dying after October 21, 1942, and before 1948, see Reg. §1.1014-2(c)(2). The modified carryover basis rules enacted by the 2001 Tax Relief Act that could have been elected for 2010 decedents' estates applied to certain community property held by the decedent and surviving spouse. Similar to the rule under §1014(b)(6), former §1022(d)(1)(B)(iv) treated the first spouse to die as owning the surviving spouse's one-half share of community property, which was eligible for the $1.3 million or $3.0 million marital basis increase, if at least one-half of the property was owned by and acquired from the decedent. Similarly, such property could have its basis

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Only community property qualifies for this step-up in basis for both spouses' halves of the property. Other forms of joint ownership do not qualify[242] for this double basis step-up unless, under applicable local law, ownership forms are regarded as community property.[243] Some community property states have remedied this disparate treatment by allowing property to be held as "community property with right of survivorship."[244] Some courts have recognized that if the spouses hold title to realty in joint tenancy or tenancy in common, but they intend to hold the realty as community property, then both halves of the property qualify for a new stepped-up basis.[245] The surviving spouse's separate property interests do not qualify for the new basis under §1014.[246] Additionally, no portion of property comprised of income in respect of decedent (IRD) qualifies for the new basis.[247] If one spouse converts separate property to community property to take advantage of the double step-up, and the other spouse dies first, the death of the first spouse to die must occur at least one year after the conversion for the double step-up to be allowed.[248]

reduced to date-of-death value, if the value was less than the pre-death basis. *See also* Rev. Proc. 2011-41, for the special rules for stepped-up basis in community property at a spouse's death for decedents that died in 2010, if the decedent's executor elected to have §1022 apply.

[242] Rev. Rul. 68-80 (no new basis step-up on wife's interest in Virginia realty held in co-tenancy, despite community property source of purchase money); *Murphy v. Commissioner*, 342 F.2d 356 (9th Cir. 1965) (no basis step-up for surviving spouse's interest in California realty originally held as community property, converted before death to joint tenancy).

[243] *See Raney v. Cerkueira*, 248 Cal.Rptr. 3d 426 (Cal. App. 2019); Rev. Rul. 87-98; Wash. Rev. Code §64.28.040 (interests held jointly by husband and wife presumed to be community property). *See also* Fla. Stat. §736.1503 (allowing for creation of community property trust where spouses may obtain benefit under §1014(b)(6)); *cf.* Jeremy T. Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 5 Nev. L.J. 704, 722–25 (2005) (discussing possibility of denial of double step up).

[244] E.g., Ariz. Rev. Stat. Ann. §33-431; Cal. Civ. Code §682.1.

[245] *McCollum v. United States*, 58-2 USTC ¶9957 (N.D. Okla. 1958) (where spouses filed Oklahoma community property law election, then took title to realty in joint tenancy while intending to hold it as community property, both halves qualified for basis step-up); *Bordenave v. United States*, 150 F. Supp. 820 (N.D. Cal. 1957) (although presumption created by joint tenancy or co-tenancy record title in California realty can be overcome by evidence of mutual intention, understanding, or agreement that realty was held as community property, presumption of joint tenancy record title not overcome here to step-up basis in both halves). *McCollum* and *Bordenave* were decided under the §1014 predecessor — 1939 Code §113(a)(5). *See also United States v. Pierotti*, 154 F.2d 758 (9th Cir. 1946) (although California realty deed stated that property was held in joint tenancy, court held that evidence was admissible to show that spouses had agreement that property was held as community property and that agreement prevailed over deed's form); Rev. Rul. 87-98 (where spouses bought property with community funds, took title as joint tenants with right of survivorship, and declared, in joint wills, that property was community property, each half interest received step-up in basis because property was considered community property under state law).

[246] *Crosby v. Commissioner*, T.C. Memo 1961-272 (where Washington domiciliary spouses agreed to transmute community property to separate property, surviving spouse's separate property received no basis step-up); *Massaglia v. Commissioner*, 286 F.2d 258 (10th Cir. 1961), aff'g 33 T.C. 379 (1959) (where spouses transmuted community property to separate property but New Mexico law did not permit such transmutation, there was no basis step-up for property sold after husband's death, because retroactive New Mexico decision validated such transmutations).

[247] §1014(c); Reg. §1.1014-1(c)(1). *See* §691. *See also Collins v. United States*, 318 F. Supp. 382 (C.D. Cal. 1970), aff'd, 448 F.2d 787 (9th Cir. 1971); Rev. Rul. 68-506; *see* III.F.2., below. For a discussion of income in respect of a decedent, see 862 T.M., *Income in Respect of a Decedent*.

[248] §1014(e).

If a couple moves from a community property state to a common law state, the double step-up in basis for their community property that they brought to the new noncommunity property state may or may not be preserved.[249]

> *Example:* Chuck and Lisa, husband and wife, live in a community property state. They have not signed any agreement transmuting their community property into separate property. Chuck received an inheritance from his Uncle Dud, which he has invested in his own name in a rental property. Lisa inherited a stock portfolio from her grandmother and holds the brokerage account in her own name. Lisa also inherited a Gauguin painting. Lisa sold this painting and placed the sales proceeds in an account that contained community property funds consisting of savings from Lisa and Chuck's wages.
>
> Chuck dies, and his estate leaves everything outright to Lisa. All of Chuck's one-half interest in community property is includible in Chuck's gross estate.
>
> Lisa enjoys a step-up in basis not only in Chuck's one-half interest in the couple's community property, but she also receives a step-up in basis in her own one-half interest in the couple's community property, although only Chuck has died. Lisa does not receive any step-up in basis in her separate property stock portfolio, but she does receive a stepped-up basis in Chuck's rental property originating in the inheritance from Uncle Dud. As for the proceeds of the sale of the Gauguin, Lisa may well be deemed to have "commingled" these sale proceeds with community property, thereby converting what would have been her separate property into community property. In the absence of evidence defeating the commingling principle, both Chuck's community one-half of this account and Lisa's one-half interest in this account would receive a stepped-up basis.

The step-up in basis produces immediate tax results in the case of oil and gas property owned as community property. In Rev. Rul. 92-37, a surviving spouse filed a joint return with the executor of her late husband covering the short tax year ending with her husband's death and her normal tax year. The IRS ruled that she was entitled to use the date-of-death value in calculating her depletion deduction in respect of their oil and gas properties.

The IRS has ruled that, in the case of a foreign couple who created a foreign trust holding assets consisting of their community property, upon the death of the first spouse, the surviving spouse would be considered as acquiring the deceased spouse's one-half share of all community property that was part of the trust assets under §1014(b)(2) and would receive a step-up or step-down in basis of the deceased spouse's one-half share of such community property, equal to the fair market value of such assets as of the deceased spouse's date of death.[250]

[249] *See* Jeremy T. Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 3 Nev. L.J. 704 (2005).

[250] PLR 201544002.

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2. *Income in Respect of a Decedent*

Section 1014(c) provides that the rules in §1014, including the double step-up in basis for community property under §1014(b)(6), do not apply to property with a right to receive an item of IRD under §691. The IRS has ruled privately that proceeds from an exchange of community assets after the death of one spouse, which qualify for nonrecognition treatment under §1031, do not constitute a right to receive an item of IRD under §691, and the surviving spouse is entitled to a stepped-up basis in her half of the community properties under §1014(b)(6).[251]

G. Holding Period for Property Sold Within One Year of First Spouse's Death

Section 1223 provides that a sale of property within one year of a decedent's death with a basis acquired under §1014 is regarded as a sale of long-term property.[252] Under prior law, sales of community property which occurred too quickly after the death of the first spouse could produce gain that was part short-term and part long-term.[253]

H. Disposition of IRAs upon First Spouse's Death

The IRS has ruled that when a surviving spouse exchanges community property interests, including her deceased spouse's community property interest in an IRA, making that entire IRA the surviving spouse's property, the IRA would not be treated as an inherited IRA under §408(d) as to the surviving spouse because it was appropriate to treat her as payee and beneficiary of the IRA. In the ruling, the deceased husband had not named an IRA beneficiary, and his estate became the beneficiary. Under his will, the residue of the estate, including the IRA, was left to a trust. The surviving spouse was deemed eligible to roll over the IRA proceeds into an IRA in her own name within 60 days of the distribution, and was not required to include in her gross income any portion of the IRA that was rolled over into an IRA in her own name.[254]

In a separate ruling, a married couple entered into a community property agreement providing that all of their property constituted community property. They created a trust on the same day. The trust was the sole beneficiary of the husband's IRA. The surviving spouse became sole trustee of the trust and, as trustee, had the power under the trust instrument and under state law to allocate the trust assets, including the IRA, between a survivor's trust and a family trust. Once both the decedent's interest in the IRA and the surviving spouse's interest in the IRA were allocated to the survivor's trust, payment from the IRA to the surviving spouse was not subject to the discretion of any third party. The IRS ruled that the surviving spouse would be treated as the payee or distributee of the IRA under §408(d)(3)(C) and §408(d)(3). As to the surviving spouse, the IRA did not constitute an inherited IRA under §408(d)(3), and she would be deemed to have received the IRA proceeds directly from her deceased husband and not from his estate or the trust.[255] Thus, she was not required to include any portion of the IRA rolled over into an IRA in her own name in her gross income.

I. Income of Registered Domestic Partners

Since the U.S. Supreme Court's decision in *Obergefell v. Hodges*,[256] requiring states to recognize same sex marriages, the use of registered domestic partnerships (RDPs) has declined. In Washington, RDPs are now only available to couples where one partner is over the age of 61.[257] In California and Nevada, RDPs are available to all couples over the age of 18 who would otherwise be able to marry.[258]

It appears that, when RDPs are treated as a community under state law, then RDPs will also be treated as a community under federal law for community property purposes and the community property rules will apply.

The IRS has ruled that a California registered domestic partner was required to report one-half of the community property income, whether wage income or income from property, on his federal income tax return.[259] As recipient of half of the community property income, he was entitled to half of the amount withheld as a credit under Reg. §1.31-1(a).[260]

In a Chief Counsel Advice Memorandum,[261] the Chief Counsel's Office stated its intention to treat income of California RDPs in the same manner as California treats community property income. Similarly, a related Chief Advice Memorandum[262] stated that the IRS can consider assets of the taxpayer's RPD in California when determining the reasonable collection potential of the taxpayer's Office in Compromise under §7122.

IRS Form 8958, *Allocation of Tax Amounts Between Certain Individuals in Community Property States*, is to be used to determine the allocation of tax amounts between married filing separate spouses or RDPs with community property rights.[263]

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[251] PLR 9829025.

[252] Section 1223(9) eliminates the one-year holding period requirement for long term capital gain qualification when the tax basis is changed by reason of being stepped up (or stepped down) at death under §1014. For further discussion of the holding period, see 852 T.M., *Income Taxation of Trusts and Estates*.

[253] *See* Rev. Rul. 59-220.

[254] PLR 201125047. *See also* PLR 201707001. For a discussion of the difference treatment of an IRA inherited by a spouse and one inherited by another person, see 367 T.M., *IRAs* (U.S. Income Series).

[255] PLR 200950053. *See also* PLR 202034002 (community property IRA allocated to subtrust for which surviving spouse was trustee and sole beneficiary; IRS ruled spouse received proceeds directly from deceased spouse), PLR 201944003 (community property IRA allocated to portion of subtrust for which surviving spouse was trustee and sole beneficiary, and over which she had general power of appointment; IRS ruled spouse received IRS proceeds directly from deceased spouse).

[256] 576 U.S. 644 (2015). For a more detailed discussion on the latest developments regarding same-sex marriage, including enactment of the Respect for Marriage Act (Pub. L. No. 117-228), see 858 T.M., *Family, Kinship, Descent, and Distribution*.

[257] Wash. Rev. Code §26.60.030.

[258] Cal. Fam. Code §297.1; Nev. Rev. Stat. tit. 11, §122A.100.

[259] Cal. Family Code §297.5(k) recognizes RDP as a community for community property purposes.

[260] PLR 201021048.

[261] CCA 201021050.

[262] CCA 201021049.

[263] https://www.irs.gov/uac/About-Form-8958. Only RDPs in Nevada (Nev. Rev. Stat. tit. 11, §122A.200), Washington (Wash. Rev. Code §26.60.080), and California (Cal. Fam. Code §297.5(k)) have community property rights. See Additional Resources for each state's statutes.

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J. Treatment of Entities Owned by Community Property Spouses

A disregarded entity can be owned by spouses as community property without causing the entity to be treated as having more than a single owner. Under Rev. Proc. 2002-69,[264] such an entity may be treated as a disregarded entity or as a partnership at the election of the marital community based on the reporting position adopted by the parties.[265]

Rev. Proc. 2002-69 is applicable to cases where the entity is jointly owned by reason of community property laws under applicable local law.[266] This presumably means that if ownership of the entity resides in both members of the marital community by operation of contract law, the entity cannot be treated as a disregarded entity but only as a partnership. Similarly, a disregarded entity formed by spouses in a non-community property state presumably will be treated as a disregarded entity even if ownership of the entity is held by both members of the marital community as tenants by the entireties. For Rev. Proc. 2002-69 to apply, formation (or acquisition) of the entity should be in the name of only one member of the marital community.

Rev. Proc. 2002-69 raises some difficult questions. Suppose Spouse 1 forms a limited liability company in a common law state, and the spouses adopt the position respected under Rev. Proc. 2002-69 that the entity is treated as a partnership. If the spouses then move to a non-community property state, is there an automatic conversion of the entity into a disregarded entity because Spouse 1 becomes the only owner?

[264] For further discussion on disregarded entities, see 704 T.M., *Disregarded Entities* (U.S. Income Series).

[265] Rev. Proc. 2002-69 does not require that the parties file a joint return, but no provision is made for the possibility that the parties will adopt inconsistent positions with respect to the entity on separate returns.

[266] Rev. Proc. 2002-69, §3.02(1).

A second issue raised by Rev. Proc. 2002-69 is the consistency requirement imposed on classification of the entity as a partnership. The revenue procedure provides that the entity will be treated as a partnership if both spouses treat the entity as a partnership and they "file the appropriate partnership returns." What if they treat the entity as a partnership but fail to file the partnership returns; for example, what if they fail to file a Form 1065 on behalf of the entity? Does this failure cause the entity to be treated as a disregarded entity even if the marital community treat the entity as a partnership on separate returns? Similarly, what if Spouse 1 treats the entity as a disregarded entity but Spouse 2 treats the entity as a partnership? Unfortunately, Rev. Proc. 2002-69 provides no default rule for inconsistent treatment and offers no analysis from which one could extend its reach.

However, the Chief Counsel's Office advised in CCA 200852001 that, based on Rev. Proc. 2002-69, an entity owned by spouses as community property was a disregarded entity rather than a partnership because the couple had never treated the entity as a partnership or filed partnership returns for the entity after its corporate dissolution. The entity, in fact, had filed a Form 1120S during audit after its administrative dissolution, but the Chief Counsel found no evidence that it had ever attempted to file an S corporation election or a check-the-box election to be treated as an association. Thus, according to the Chief Counsel, the entity could only be classified as a partnership or a disregarded entity, and, though ordinarily it would be a partnership (as it had two owners), the IRS should accept the taxpayers' position, in accordance with Rev. Proc. 2002-69, that the entity was a disregarded entity owned by the spouses, who were the sole proprietors of the business.[267]

[267] The Chief Counsel also advised in CCA 200852001 that the husband and wife were the employers liable for employment taxes paid to the entity's employees after the administrative dissolution.

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IV. Estate Tax Consequences

A. *Property Owned at Death*

Section 2033 requires the inclusion in a decedent's gross estate of the value of all property to the extent of the decedent's interest at the time of his or her death. Neither the Code nor the regulations contain special provisions for the inclusion of property characterized by the laws of community property jurisdictions. The application of §2033 depends on local law definitions of interests in property.

In the case of a person who dies leaving a surviving spouse, the application of §2033 to local property rules generally results in the inclusion of the value of all separate property owned by the decedent and the value of one-half of the community property owned at death by the decedent and his or her spouse.[268]

The amount of community property includible in the gross estate is not increased even if the surviving spouse, before or after the decedent's death, elects to give up his or her interest in the community property and to accept benefits given by the first spouse to die under his or her Last Will.[269] The amount of community property includible in the estate of the first spouse to die has been held not to be affected by an agreement between the sole beneficiary under the decedent's Last Will and the surviving spouse, where the latter accepted, in settlement of the dispute between the beneficiary and the surviving spouse about the amount of community property, a sum considerably less than the value of his or her interest in that property.[270]

B. *Reliance upon Record Title*

It may prove unwise for a planner to rely upon record title as the sole indication of the class of property with which he or she is dealing. Title to all of the community property in a surviving spouse's name alone does not prevent a finding that the deceased spouse's estate owns a community property interest. Characterization as community or separate depends on the character of the property used to purchase the property and other factors; title is not dispositive.[271] The strong presumption in favor of community property and the potential for commingling can also interfere with the character of property titled in the name of one spouse. Also, an operative community property agreement may override all considerations of record ownership.[272]

[268] *See United States v. Silverman*, 859 F.2d 1352 (9th Cir. 1988) (Cal. law). The nature of community ownership has a profound effect on "fair market value." *See, e.g., Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982). *Cf.* TAM 8302005.

[269] GCM 7773 (1930), *superseded by* Rev. Rul. 67-383 (Tex. law); *Estate of Broadbent v. Commissioner*, 20 B.T.A. 890 (1930). *But cf. Rodiek v. Helvering*, 87 F.2d 328 (2d Cir. 1937) (German law). *See also Estate of Bressani v. Commissioner*, 45 T.C. 373 (1966).

[270] *Smith v. Commissioner*, B.T.A. Memo Dec. ¶39,416 (1939) (Wash. law).

[271] *In re Estate of Stockman*, 798 P.2d 817 (Wash. App. 1990); *Estate of Borghi*, 219 P.3d 932 (Wa. 2009).

[272] *Estate of Arbuthnot v. Commissioner*, 47 B.T.A. 1042 (1942). *See also Caswell v. United States*, 205 F. Supp. 576 (N.D. Cal. 1962).

C. *Federal Preemption Property*

Federal preemption may merely alter the normal state law disposition pattern for the decedent's interest in community property. It may go much further — creating separate property in the person identified as owner by the applicable federal statute. To the extent includible at all,[273] these latter interests are included at their full value in the decedent owner's gross estate. The estate of the spouse not designated as owner by federal law should, by the same line of reasoning, include no interest in such property.

In a 1905 decision involving the federal homestead laws as they applied to land in Washington State,[274] the Supreme Court concluded that the Congress might prescribe the manner in which land being homesteaded would devolve upon a settler's survivors who died before the patent was obtained. When that manner differed from the manner prescribed by state community property law, the federal law preempted.

Federal preemption extended to National Service Life Insurance policies in 1950,[275] to federal savings bonds in 1962,[276] to Railroad Retirement Act benefits (and probably Social Security benefits) in 1979,[277] and to military retirement benefits in 1981,[278] a result later changed by legislative amendment.[279]

Federal preemption also applies to pension benefit payments from qualified plans. In *Boggs v. Boggs*,[280] the Supreme Court reversed the Fifth Circuit and held that Louisiana community property law was preempted by the Employee Retirement Income Security Act of 1974 (ERISA),[281] so that a deceased nonemployee spouse had no community property ownership rights in her husband's qualified plan.

There is no definitive answer as to whether community property interests in intellectual property that is governed by federal law, such as copyrights and patents, are preempted by federal law. In *Rodrigue v. Rodrigue*,[282] the Fifth Circuit held that the wife had a community property interest in the husband's copyright that was not preempted by federal copyright law. The extension of the court's reasoning to other community property states is unclear.[283]

[273] Most railroad retirement, social security, and noncontributory military retirement benefits are, of course, excepted. *See* Rev. Rul. 60-70, *modified by* Rev. Rul. 73-316 (Railroad Retirement); Rev. Rul. 55-87, Rev. Rul. 67-277 (Social Security).

[274] *McCune v. Essig*, 199 U.S. 382 (1905) (Wash. law).

[275] *Wissner v. Wissner*, 338 U.S. 655 (1950). *See also* Rev. Rul. 56-603 (rule extends to proceeds of life insurance policies issued under World War Veterans' Act of 1924 (referring to the World War Adjusted Compensation Act, Pub. L. No. 68-120), the National Service Life Insurance Act of 1940, Pub. L. No. 76-801, and the Servicemen's Indemnity Act of 1951, Pub. L. No. 86-497).

[276] *See Free v. Bland*, 369 U.S. 663 (1962) (Tex. law).

[277] *See Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979).

[278] *McCarty v. McCarty*, 453 U.S. 210 (1981).

[279] Uniformed Services Former Spouses' Protection Act, Pub. L. No. 97-252, §1001–§1006. *See In re Thomas*, 47 B.R. 27, 32 (1984).

[280] 520 U.S. 833 (1997).

[281] Pub. L. No. 93-406.

[282] 218 F.3d 432 (5th Cir. 2000).

[283] *See* Dane S. Ciolino, *How Copyrights Became Community Property (Sort of) Through the Rodrigue v. Rodrigue Looking Glass*, 47 Loy. L. Re. 631 (2001); J. Wesley Cochran, *It Takes Two to Tango!: Problems with Community Property Ownership of Copyrights and Patents in Texas*, 58 Baylor L.Rev. 407 (2006). *See also Berry v. Berry*, 277 P.3d 968 (Haw. 2012) (citing

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D. Effect of Dower and Curtesy Rule

Section 2034 states that the deceased spouse's estate includes all of the property passing to the surviving spouse as dower or curtesy, or under a statute creating a property right of the survivor in lieu of dower or curtesy. In other words, the survivor's right of dower or curtesy is not treated as property of the survivor at the time of death. It is settled law that Section 2034 does not, however, bring the surviving spouse's community property interest into the deceased spouse's estate because community property rights are not "in lieu of dower or curtesy."[284] Texas homestead property has been held includible under §2034 as a dower substitute.[285] In some community property jurisdictions, quasi-community property statutes create a right of the survivor to one-half of the domiciled decedent's separate property that would have been community if earned while the couple were domiciled in the community property state.[286] Those rights appear to be interests in the nature of dower or curtesy.

> *Example:* Pat and Dana lived most of their married life in Oregon, a separate property state. Pat was the wage earner and Dana was a stay-at-home spouse, and all their property was in Pat's name. Upon retirement, Pat and Dana moved to California. If Dana dies first, all the property is in Pat's name and is considered Pat's separate property, so none of the property is included in Dana's estate. If Pat dies first, Dana will be entitled to a quasi-community property share of the property but all of the property will be included in Pat's estate under §2034.

E. Transfers Within Three Years (or in Contemplation) of Death

1. Current Law

A decedent's gross estate under §2035 includes only transfers within the three-year period before death that are either included under §2036, §2037, §2038, or §2042, or would have been included under any of these sections if the interest had been retained by the decedent on the date of his or her death.[287] An absolute transfer is not included; however, an amount equal to the gift tax on that transfer is includible.[288] These provisions, seemingly designed to allow "freezing" of the value of the transfer for unified transfer tax purposes, have at least one side-effect: the donee retains the donor's basis in the transferred property.[289] There has been an issue of whether life insurance premium payments cause the policy proceeds to be included in the insured spouse's estate. Paying life insurance premiums out of community property produces partial inclusion of insurance proceeds.[290]

2. Prior Law

Prior to 1977, community property transfers in contemplation of death were considered in the same manner as transfers of any other property — the intention of the transferor.[291] The inclusion, however, was limited to 50% of the transferred property's value.[292] Moreover, the IRS ruled that the husband, in his role as manager of the community, could make a taxable transfer in contemplation of his wife's death, resulting in the inclusion of one-half of the value of the property transferred in the gross estate of the wife.[293]

The Tax Reform Act of 1976[294] eliminated "contemplation of death" as the test of includibility. With a single exception, all property transferred during the three-year period ending on the date of the decedent's death was includible. The 1976 provision exempted "any gift excludible in computing taxable gifts" under the gift tax annual exclusion.

The provision was amended in the Revenue Act of 1978[295] so that it excluded "any gift to a donee made during a calendar year if the decedent was not required by §6019 to file any gift tax return with respect to such donee." Thereafter, the annual exclusion amount passed gift- and estate-tax free to the donee.

The statute provided, however, that the exception "shall not apply to any transfer with respect to an insurance policy."[296] But the plain language of this proviso was modified by a flat statement in the Senate Report that "… the exception does apply to any premiums paid (or deemed paid) by the decedent within three years of the death to the extent that such payments would not have resulted in the inclusion of the policy in the decedent's gross estate under prior law."[297]

Rodrigue, 218 F.3d 432, and *Worth v. Worth*, 241 Cal.Rptr. 135 (Cal.Ct.App.1987)).

[284] *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958) (Tex. law); *Hernandez v. Becker*, 54 F.2d 542 (10th Cir. 1931) (N.M. law regarding decedent wife); *Sampson v. Welch*, 23 F. Supp. 271 (S.D. Cal. 1938), vac'd on other grounds, 40 F. Supp. 1014 (S.D. Cal. 1941), aff'd (per curiam) *sub nom.*, *Overton v. Sampson*, 138 F.2d 417 (9th Cir. 1943) (Cal. law); *Bigelow v. Commissioner*, 38 B.T.A. 377 (1938), withdrawn, 39 B.T.A. 635 (1939) (Cal. law).

[285] *Estate of Johnson v. Commissioner*, 718 F.2d 1303 (5th Cir. 1983) (Tex. law); *Estate of Hinds v. Commissioner*, 11 T.C. 314 (1948), aff'd on other issues, 180 F.2d 930 (5th Cir. 1950) (Tex. law).

[286] *See, e.g.*, Wash. Rev. Code §26.16.220 (1997).

[287] §2035(a) (pre-1997 Act §2035(d)). The absence of §2039 from the list may permit the transfer by parents to children of significant benefit payments otherwise taxable at date-of-death value, and subject to annual exclusions, within short periods before the death of one of the parents. The absence of §2040 is of similar significance.

[288] §2035(b) (pre-1997 Act §2035(c)).

[289] §1014. A gift of community property within three years of a pre-1982 death produced a 50% inclusion, but 100% date-of-death-basis. §1014(b)(6). The adjustment is not available if no portion of the interest is includible in the gross estate. §1014(b)(6).

[290] *See Knisley v. United States*, 901 F.2d 793 (9th Cir. 1990); *Lester v. United States*, 947 F.2d 950 (9th Cir. 1991); *Estate of Schnack v. Commissioner*, 848 F.2d 933 (9th Cir. 1988); *Estate of Kurihara v. Commissioner*, 82 T.C. 51 (1984); *Estate of Hass v. Commissioner*, T.C. Memo 1986-63; *Estate of Baratta-Lorton v. Commissioner*, T.C. Memo 1985-72, aff'd, 787 F.2d 597 (9th Cir. 1986).

[291] *See, e.g.*, *Hammond v. Westover*, 97 F. Supp. 753 (S.D. Cal. 1951); *Estate of Lynch v. Commissioner*, 35 T.C. 142 (1960); *Estate of Larsh v. Commissioner*, 8 T.C.M. 799 (1949); *Estate of Girvin v. Commissioner*, 3 T.C.M. 1290 (1944).

[292] *See Estate of Humphrey v. Commissioner*, 162 F.2d 1 (5th Cir.) (Tex. law); *Estate of Lynch v. Commissioner*, 35 T.C. 142 (1960) (Ariz. law); Rev. Rul. 56-408.

[293] Rev. Rul. 56-408 (relying on *City Bank Farmer's Tr. Co. v. McGowan*, 323 U.S. 594 (1945)). Contemplation of death cases may yet be litigated. *See, e.g.*, *Bailey v. United States*, 84-1 USTC ¶13,566 (M.D. La. 1984); *Estate of Green v. Commissioner*, T.C. Memo 1986-511.

[294] Pub. L. No. 94-455, §2001(a)(5), enacting former §2035(b)(2).

[295] Pub. L. No. 95-600, §702(f)(1).

[296] Former §2035(b)(2).

[297] S. Rep. No. 95-745, at 87 (1978).

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Conversions of community property into property held by husband and wife as tenants in common produced two, perhaps three, results, depending upon the nature of the wife's interest prior to conversion. If that interest was the normal interest of the wife in community property, the one court passing on the point has held that no "transfer" has occurred.[298] A similar conversion of pre-1973 New Mexico community property involved a transfer by husband to wife of his survivor's interest in her half of the property,[299] a result that may still be possible in the case of community property arising under foreign law and, theoretically at least, to whatever remains of California pre-1927 community property. The value to be included in the husband's gross estate for conversions within three years of death was probably determined under these rules.

Payment in contemplation of death of premiums on policies of life insurance owned by a noninsured spouse raised issues as to the amount of the policy proceeds includible in the insured spouse's gross estate. Where the policy was purchased prior to the beginning of the pre-1977 three-year presumption period, the usual result was inclusion of half of the value of the premiums paid during that period.[300] The purchase of the policy during the presumption period resulted in an inclusion of half the policy proceeds.[301]

The Economic Recovery Tax Act of 1981 (ERTA) repealed, for most purposes, the general rule of inclusion for all property transferred during the three-year period ending on the date of the decedent's death.[302] The Taxpayer Relief Act of 1997 (1997 Act),[303] although modifying §2035 for clarity, was not intended to change its substance and operation. Thus, as stated above, for deaths in after 1981, the inclusion of transfers made within three years of death is limited to transfers included under §2037, §2038, or §2042, or would have been included under any of these sections if the retained interest was still held by the decedent on the date of death. Even within the narrow area that remained, ERTA enlarged an earlier exclusion simply by continuing to allow untaxed any gift for which a gift tax return is not required.[304] This exempted from the unified transfer tax gifts of present interests valued at no more than the per donee per year annual gift exclusion amount and gifts for which a marital deduction are allowed.[305]

[298] *Rickenberg v. Commissioner*, 177 F.2d 114 (9th Cir. 1949) (pre-1927 and post-1927 Cal. community property).

[299] Rev. Rul. 70-401 (N.M. law), *modified by* Rev. Rul. 75-551, which limited the application of Rev. Rul. 70-401 to pre-July 1, 1973 transactions.

[300] *Bintliff v. United States*, 329 F. Supp. 1356 (E.D. Tex. 1971), aff'd as to this issue, 462 F.2d 403 (5th Cir. 1972) (Tex. law); *Cully v. United States*, 87-2 USTC ¶13,725 (E.D. Wash. 1987); *Estate of Baratta-Lorton v. Commissioner*, T.C. Memo 1985-72, aff'd, 787 F.2d 597 (9th Cir. 1986); Rev. Rul. 71-497 (Situation 1).

[301] *Bel v. United States*, 452 F.2d 683 (5th Cir. 1971). *See Cully v. United States*, 87-2 USTC ¶13,725 (E.D. Wash. 1987).

[302] Pub. L. No. 97-34, §424.

[303] Pub. L. No. 105-34, §1310.

[304] *See* §2035(c)(3) (pre-1997 Act §2035(b)(2)).

[305] §6019, §2503(b). The exemption does not apply to "a transfer with respect to a life insurance policy." §2035(c)(3) (pre-1997 Act §2035(b)(2) (last sentence)). This section encompasses the transfer of premiums used to fund the policy, as well as to the policy's transfer itself. *Knisley v. United States*, 901 F.2d 793 (9th Cir. 1990).

F. *Incomplete Transfers*

1. *Transfer with Retained Life Estate*

a. *General Rule*

The transfer by both spouses of community property, where each retains a life estate in the property, is subject to normal treatment under §2036. One-half of the value of the property is included in the gross estate of each spouse.[306] When the transfer is made by both spouse, but the possession, enjoyment or right to income is given to one of the spouses, only the estate of the spouse in enjoyment will have estate tax liability, and only for the half that such spouse contributed — unless under applicable local law, the income remains community property.[307]

b. *Community Character of Income from Separate Property*

It is possible in most, if not all, community property jurisdictions for spouses to convert, by agreement or conveyance, the community property of both into the separate property of one spouse. In a number of the community property jurisdictions, the income earned by the separate property of spouses during marriage is community income, creating a risk of estate inclusion for both spouses after the conversion.[308]

The IRS has ruled that the value of separate property under Texas community property law transferred to a spouse before death is not included in the gross estate of the deceased spouse under §2036 because the deceased donor spouse has a mere expectancy, not a right, to the income from the property post-transfer.[309] The treatment Texas law affords gifts to married per-

[306] *Ahmanson Found. v. United States*, 733 F.2d 623 (9th Cir. 1984) (Cal. law); *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981) (Cal. law). *See also Estate of O'Brien v. Commissioner*, T.C. Memo 1978-457 (Tex. law).

[307] Under the prior law of some states, the husband acting as the community property's manager could make donative transfers of property without the wife's consent. A wife in possession or enjoyment of a life interest in community property so transferred could not avoid estate tax liability on the grounds that she neither personally transferred nor consented to the community property's transfer. *See Katz v. United States*, 382 F.2d 723 (9th Cir. 1967) (Cal. law). Today, all community property jurisdictions have abandoned the husband-manager approach in favor of equal management. *See* II.E., above.

[308] *See* Thomas R. Andrews, *Income From Separate Property: Towards a Theoretical Foundation*, 56 Law & Contemp. Probs. 171 (1993).

[309] Rev. Rul. 81-221 (Tex. law). The IRS originally asserted in *Commissioner v. Estate of Hinds*, 180 F.2d 930 (5th Cir. 1950) (concurring opinion — Tex. law), that, although the husband transferred the principal of community property into trust as his wife's separate property, the local rule for the community character of income from separate property resulted in his having made a transfer with retained life income in his one-half interest. The court stated that the spouse had complied with the requirements of state law that the income from separate property would be regarded as separate property when a clear, definite, and distinct intention to make it separate property was expressed by the spouses. There the matter lay for 25 years. Then, Rev. Rul. 75-504, *revoked by* Rev. Rul. 81-221, signaling the start of the most recent (and, one hopes, the final) episode in the story. In that the ruling, the IRS declined to follow *Hinds*, declaring that "[u]nder Texas community property law, although the separate property of one spouse may be transferred to the other spouse as separate property … the ownership interest of the donor spouse in that income cannot be eliminated, even by statute, since such income cannot be separate property under the Texas Constitution." Rev. Rul. 75-504. The Fifth Circuit's opinion in *Estate of Wyly v. Commissioner*, 610 F.2d 1282 (5th Cir. 1980) (Tex. law), demolished the IRS's theory entirely. In the court's view, the donor's community property interest in the income from the property transferred (1) "is so limited,

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sons of income in trust may be regarded as exceptional, however. Absent a gift of the principal out of which the income arises, these are gifts of separate income. Accumulations of such separate income constitute separate property.[310]

More recently in *Estate of Hoffman v. Commissioner*,[311] the Tax Court held that an incorrect allocation of income and death taxes during the administration of the husband's estate was treated as the wife's contribution to a trust under his will of which she was life income beneficiary. The Tax Court held that the trust corpus, to the extent it was overfunded, was includible under §2036.

Practice Note: The reader should appreciate one underlying point. The "hypertechnical basis" and the "anomalous" sort of "taxing rationality" has become characteristic of enforcement efforts in this area.[312]

c. Character of the Power of Management

In all community property jurisdictions, both spouses have a presently vested, equal, undivided interest in all community property with equal management powers.[313] Traditionally, a husband had more or less plenary powers of management of community property during coverture. The Commissioner initially took the position that this power was a right "to designate the persons who shall possess or enjoy the property or the income therefrom" resulting in estate inclusion under §2036(a)(2).[314] After initial successes with this argument,[315] the Ninth Circuit held in *United States v. Goodyear*[316] that a husband's statutory management power was taxable neither as a transfer with the retained power to alter, amend, or revoke, nor as a transfer taking effect at death.[317]

d. The Surviving Spouse's, or Widow's, Election

Transfers with retained life estates occur frequently in community property jurisdictions in a unique situation: testamentary transfers in which one spouse purports to dispose of all of the community property. In the traditional example, the husband creates a testamentary trust of all of the marital property, giving life income to the wife, remainders over to the wife or another. Because, under the laws of all of the community property states, the one spouse may transfer by will no more than his or her half-interest in community assets, the effect is to force the surviving spouse to make an ordinary common law election. The surviving spouse may choose to claim his or her half of the community property absolutely and in fee, the decedent spouse has no power to dispose of it, or the surviving spouse may elect to accept the benefit conferred by the decedent spouse's will. In doing so, the surviving spouse must consent to the decedent spouse's disposition of the surviving spouse's half of the community property. The surviving spouse cannot claim both. It has been held consistently that the surviving spouse's election to accept the life estate in the whole of the community property constitutes a transfer of his or her half of the community property with a retained life estate.[318] This is also known as "the widow's election."[319]

Cases involving life insurance settlement options and life insurance trusts in which the surviving spouse is entitled to life income from the proceeds of insurance have come to the same result. Because the surviving spouse is half-owner of the insurance policy, his or her agreement to or acquiescence in the disposition constitutes a transfer by the surviving spouse with life income retained.[320]

In each of the foregoing cases, it was asserted that the transfer by the wife was made for an adequate and full consideration in money or money's worth, so that the value of her half-interest, included in her gross estate by reasons of §2036, should be reduced by the value of the consideration received by

contingent, and expectant that it does not amount to a 'right to income'"; (2) because it arises only because of the Texas Constitution, it is not an interest that is "retained"; and finally, (3) for the same reason, the interest has not arisen "under" the transfers concerned. The IRS's response was Rev. Rul. 81-221 (Tex. law), which adopted the Fifth Circuit's view, and revoked Rev. Rul. 75-504.

[310] *Wilmington Tr. Co. v. United States*, 4 Cl. Ct. 6 (1983), aff'd, 753 F.2d 1055 (Fed. Cir. 1985).

[311] 78 T.C. 1069 (1982) (Cal. law).

[312] *Estate of Deobald v. Commissioner*, 444 F. Supp. 374 (E.D. La. 1977) (La. law). The IRS asserted that the wife's failure to make a notarial declaration designating all income as her paraphernal property resulted in the husband's reservation of a community income interest in the husband's separate property that he transferred to his wife to be her separate property. At the husband's death, one-half of the property's value should have been included in his estate, ran the argument. The court concluded that the husband had not retained an interest in the stock "in a manner as anticipated by §2036(a)." The court held, in short, that he had not "retained" … "under" the "transfer." In the course of chiding the IRS for "its lack of diligence, even after the Revenue Ruling [i.e., 75-504]," the Fifth Circuit in *Wyly* cited *Deobald* and reported that the government had asserted before *Deobald* that the case had not been appealed through inadvertent error. The care taken to adopt the second ("retained … under") ground of decision, although only two members of the three-judge panel subscribed to that ground, is some indication that the Fifth Circuit is disinclined to review another *Deobald*. While the IRS may yet place the issue before the Tax Court is thus possible, but improbable.

[313] *See* II.E., above.

[314] For the IRS's initial successes with this argument, *see Sampson v. Welch*, 23 F. Supp. 271 (S.D. Cal. 1938); *Bigelow v. Commissioner*, 38 B.T.A. 377 (1938), withdrawn, 39 B.T.A. 635 (1939).

[315] *See Sampson v. Welch*, 23 F. Supp. 271 (S.D. Cal. 1938); *Bigelow v. Commissioner*, 38 B.T.A. 377 (1938), withdrawn, 39 B.T.A. 635 (1939).

[316] 99 F.2d 523 (9th Cir. 1938).

[317] *Goodyear* turned on an interpretation California statute's application. Nevertheless, after four decades, it seems safe to conclude that Goodyear settled the point for all community property jurisdictions. *See Sampson v. Welch*, 40 F. Supp. 1014 (S.D. Cal. 1941) (supplemental opinion vacating earlier opinion), *aff'd sub nom., Overton v. Sampson*, 138 F.2d 417 (9th Cir. 1943) (*per curiam*); *Bigelow v. Commissioner*, 38 B.T.A. 377 (1938), withdrawn, 39 B.T.A. 635 (1939) (supplemental opinion vacating earlier opinion); *see also Katz v. United States*, 382 F.2d 723 (9th Cir. 1967) (citing *Goodyear* with approval).

[318] *Gradow v. United States*, 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990) (Cal. law); *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962) (Tex. law); *Estate of Bomash v. Commissioner*, 50 T.C. 667 (1968), rev'd on other grounds, 432 F.2d 308 (9th Cir. 1970) (Cal. law). Earlier cases held the elected interest to be depreciable. *See, e.g., Estate of Christ v. Commissioner*, 54 T.C. 493 (1970), aff'd, 480 F.2d 171 (9th Cir. 1973); *see also Mfr. Hanover Tr. Co. v. Commissioner*, T.C. Memo 1969-132 (cost of life estate is amortizable even though income is tax-exempt). Since 1989, depreciation deductions are no longer allowed such a "term interest in property" for any period during which a "related person" is the beneficiary in remainder. §167(e). The surviving spouse's election may be an accidental victim of the provision. *See* J. Martin Burke & Michael K. Friel, Taxation of Individual Income 326 (11th ed. 2015).

[319] The doctrine is not confined to widows. It bears its name because, to date, the surviving spouses involved in its development have all been wives. Moreover, as one case counsels, it is not a doctrine confined in its operation to community property. *See Sherman v. United States*, 79-1 USTC ¶13,288 (E.D. Va. 1979) (Va. law). Occasionally, the election appears unanticipated by the decedent. *See, e.g., Ahmanson Found. v. United States*, 733 F.2d 623 (9th Cir. 1984); *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981).

[320] *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969) (Tex. law); *Whiteley v. United States*, 214 F. Supp. 489 (W.D. Wash. 1963).

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her for the transfer. For a discussion of adequate consideration for a surviving spouse's election, see V.D.3., below.

This is a difficult conceptual problem which veils obvious tax advantages in the surviving spouse's estate. In the cases in which the surviving spouse has elected to take life income in all of the community assets (thereby giving up the power to dispose of the remainder interest in his or her half of the community property), the value of his or her one-half share of the former community assets has been set off against the actuarial value at his or her decedent spouse's death of the surviving spouse's life estate in the decedent spouse's share of those assets.[321]

Accepting less than all the income from the community assets creates a different situation. In *Estate of Bomash v. Commissioner*,[322] the surviving spouse elected to take only 50% of the income from the husband's testamentary trust. There, the court held that only 50% of her one-half share in the community property was includible under §2036. On appeal, the Ninth Circuit ordered her entire one-half share to be included in her gross estate and allowed no setoff for any consideration proceeding from her husband.[323]

Comment: Unequal allocation of debts, expenses and taxes normally produces an ultimate share of the decedent in the community property that is substantially smaller than that of the surviving spouse.[324]

The creation by the decedent spouse, in addition to a life income interest, of a general testamentary power of appointment over the community property will defeat the device entirely. As to the decedent spouse's share of the community, the surviving spouse has a general power of appointment. As to the surviving spouse's own portion, the transfer remains totally "incomplete" until his or her death. The surviving spouse has retained the life estate and the power to appoint the remainder. Nothing has been given up.[325]

Practice Tip: The surviving spouse's election produces a different "transfer" for gift tax purposes than it does for estate tax purposes. As to the former, what is transferred is the remainder interest in the surviving spouse's share; as to the latter, his or her entire share is transferred. Moreover, in the latter instance, the date-of-transfer value of the consideration offsets the date-of-death (rather than date-of-transfer) value of the share of community property transferred.[326] Finally, note that if the beneficiaries in remainder are family members, the retained interest may be subject to the special Chapter 14 valuation rules.[327]

e. *The Danger of Converting Community Property into Separate Property*

Katz v. United States[328] suggests a dangerous possibility in community property transfers with retained life estates. There, the IRS simply asserted that by transferring community property in trust with the income payable to the husband during his lifetime and then to the wife and children, the spouses had converted the property into the separate property of the husband. Assuming the normal situation, in which only half of the community assets will be taxable at the death of each of the spouses, substantial transfers of community property with retained life estates have a definite place in community property estate planning. Had the IRS succeeded in this case (it did not), the inclusion of the value of the entire trust principal in the estate of the husband, coupled with a nondeductible terminal interest in the wife, might have been disastrous. The possibility that the argument might succeed in another circuit or under other state laws in the same circuit cautions extreme care in avoiding unintended conversion of community property into separate property when reserved life estates in spouses are involved.[329]

Practice Note: The *Katz* case merits an additional observation. In a footnote, the court observed that Mr. and Mrs. Katz had resided in common law property jurisdictions during all of the husband's working life, and that the assets placed in trust in California came primarily from the husband's earnings while residing outside of California. The court remanded the matter to determine what portion of the assets transferred in trust were in fact California community property. Were the wife to fail in her attempt to prove that the assets had been converted by agreement into community property, the result might again have been the creation of a nondeductible terminable interest. The footnote in the Katz case underscores the importance of a careful determination of the actual character of property asserted by a client to be community property, even though the

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[321] *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962); *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969); *Whiteley v. United States*, 214 F. Supp. 489 (W.D. Wash. 1963). The periodic changes in actuarial value prompted by changes in interest rates made long-term results unpredictable. Despite language in former Reg. §20.2031-7 (*see* T.D. 6296, 23 Fed. Reg. 4529 (June 24, 1958), requiring its use for "estates of decedents dying on or before December 31, 1970"), this regulation (prescribing values at 3 1/2) was applied in a case involving the estate of a woman dying in 1971, for a life estate arising from a surviving spouse's election that occurred in 1958. *Estate of Simmie v. Commissioner*, 69 T.C. 890 (1978), aff'd, 632 F.2d 93 (9th Cir. 1980). The enactment of §7520 may eliminate some of the problems in the area.

[322] 50 T.C. 667 (1968), rev'd on other grounds, 432 F.2d 308 (9th Cir. 1970).

[323] Divorce can produce a nearly parallel fact pattern. *Compare United States v. Past*, 347 F.2d 7 (9th Cir. 1965) (Cal. law) *with Estate of Haskins v. United States*, 357 F.2d 492 (9th Cir. 1966) (Cal. law). *See* David P. Miller, *Some Estate Tax Consequences of a Community Property Divorce Settlement*, 18 Stan. L. Rev. 910 (Apr. 1966).

[324] *See, e.g., Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957) (Cal. Law; original shares of $711,000 each were reduced to the decedent's $295,000 versus his surviving spouse's $584,000).

[325] *Estate of Steinman v. Commissioner*, 69 T.C. 804 (1978) (Cal. law), may well arrive at a proper result, but en route to that result employs some language that implies that §2041 can apply to powers of which a decedent was the donor. The regulations have provided to the contrary for decades. Reg. §20.2041-1(b)(2). *See* former Reg. §1.105, §81.24(a)(2) (1954). The gift tax consequences are consistent. *See Robinson v. Commissioner*, 75 T.C. 346 (1980), aff'd, 675 F.2d 774 (5th Cir. 1982) (Tex. law).

[326] *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962). Trust administrators must realize that a surviving spouse's election trust is part ordinary trust and part grantor trust. Trust income should be reported by accounting for ordinary trust items on a Form 1041 and grantor trust items on a separate attachment. Reg. §1.671-4. On the surviving spouse's death, the income from that portion of the trust created by the first of the spouses to die is reported using the cash method, with undistributed required-distribution amounts becoming income in respect of a decedent ("IRD"). Reg. §1.652(c)-2, §1.662(c)-2. The grantor-trust income must be reported as IRD, whether or not distributed. Reg. §1.671-3(a)(1). Since the principal amounts in the two trusts are seldom equal (*see Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938) (Wash. law) (discussed at IV.L.1., below); *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957)), the reporting problems that these trusts present can be daunting.

[327] *See* V.D.3., below.

[328] 382 F.2d 723 (9th Cir. 1967) (Cal. law).

[329] *Cf.* Idaho Code §32-906A (1996).

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restrictions on the marital deduction have since been eased in some respects.

2. *Transfers to Take Effect at Death*

There is at the present time no clear law regarding the impact of §2037 on community property. In only one case has a court been called upon to discuss the subject, and in that case the court declined to do so.[330] One should assume that the general principles of community property includibility are applicable. It is unlikely that the management power of a decedent spouse would be regarded as a "power of disposition" under §2037(b).[331] It may be necessary in dealing with the survivorship and reversionary interest requirements of §2037 simply to regard the trust of community assets as if it were two separate trusts and evaluate the requirements settlor-spouse by settlor-spouse.

3. *Revocable Transfers*

United States v. Goodyear[332] stated the principle that the decedent spouse's power of management over the community assets is not the power to alter, amend, or revoke. When, in a transfer of community property, a power to alter, amend, or revoke is specifically reserved, the normal rules of includibility apply: the estate of the spouse to whom the power of revocation is reserved must include the property transferred. In community property jurisdictions, this means one-half of the value of community property.[333]

It has been held that when such power terminates upon the death of the decedent spouse, the resultant transfer of the surviving spouse's half-interest becomes a taxable gift by the surviving spouse.[334] The holding turns on the theory that the transfer of the surviving spouse's one-half interest in the trust principal was incomplete by reason of the decedent spouse's power held (it seems) as the agent of his or her spouse. The planner of such a transaction must therefore consider the probability of the inclusion of the surviving spouse's half in his or her gross estate, under the revocable transfer provisions, be he or she the first of the spouses to die.

The result that would arise in either estate when the power is reserved to both spouses as individuals is difficult to predict.[335]

A transfer of separate property into a revocable trust was held by the Board of Tax Appeals to be fully includible in the gross estate of the settlor spouse despite a subsequent agreement between the spouses making all their property community property. In light of the fact that the settlor remains the beneficial owner of property held in a revocable trust (and that it is quite likely that the result would be different were he or she to revoke the trust, enter into the agreement, and then — in conjunction with his or her spouse — recreate the trust), the holding is questionable.[336]

Now revoked Rev. Rul. 53-48[337] held that the insurance policies on the life of a married man in Louisiana or Texas, payable to a beneficiary other than his estate, are, in the event that his wife predeceases him, includible in her gross estate to the extent of one-half of the value of such policies "as her interest in a community asset or as a revocable transfer" under §2038.

The possibility of §2038 inclusion arises here despite the fact that the whole transfer remains subject to the power of revocation after the death of the spouse in whose gross estate one-half the value of the property transferred is included.[338]

G. Annuities

1. *Current Law*

Section 2039 provides that the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent, under certain contracts, agreements, or plans is included in the decedent's estate to the extent the value is attributable to amounts paid by the decedent or his employer. There is no longer a special exception for annuity interests created by community property laws.

The Department of Labor's view that federal law preempts state community property laws[339] may create radical change in the tax treatment of community interests held in pension plans by non-participants who predecease participant spouses. Reinforced by the ruling of the Ninth Circuit in *Ablamis v. Roper*[340] that the decedent nonparticipant spouse could not bequeath her interest in plan benefits to her children, the IRS ruled that the benefits were nevertheless includible in the nonparticipant spouse's gross estate under §2039.[341] In arriving at this rather surprising result, the author of the technical advice relied on the unreported lower court decision in *Ablamis*, rejecting a

[330] *Estate of Davis v. Commissioner*, 51 T.C. 361 (1968) (Cal. law).

[331] *See United States v. Goodyear*, 99 F.2d 523 (9th Cir. 1938) (where the predecessor to §2037 was held inapplicable).

[332] 99 F.2d 523 (9th Cir. 1938).

[333] *Estate of Casey v. Commissioner, 55 T.C. 737 (1971); Estate of Davis v. Commissioner*, 51 T.C. 361 (1968) (revocable oral trust under California law). *See also Ahmanson Found. v. United States*, 733 F.2d 623 (9th Cir. 1984) (Cal. law); *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981) (Cal. law). *Zirjacks v. Scofield*, 197 F.2d 688 (5th Cir. 1952) (Tex. law — 1942–48 statute, discussed in IV.F.3., above); *Bank of Am. Nat'l Tr. & Sav. Ass'n v. Rogan*, 33 F. Supp. 183 (S.D. Cal. 1940).

[334] *See Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958) (Tex. law).

[335] *See Zirjacks v. Scofield*, 197 F.2d 688 (5th Cir. 1952). Both §2038 and §2041 might be involved. *See* §2041(b)(1)(B) and §2041(b)(1)(C)(i) (powers jointly exercisable by donor and third party).

[336] *Bank of Am. Nat'l Tr. & Sav. Ass'n v. Commissioner*, 43 B.T.A. 695 (1941) (Cal. law).

[337] In revoking Rev. Rul. 53-48, Rev. Rul. 94-69, pointed out that under Louisiana law, "the presumption that property in the possession of either spouse during a marriage is community property does not apply to a life insurance policy transferred by or between spouses." It also stated that "The payment of premiums on the policy [from community funds] does not affect the status of the policy in Louisiana as the separate property of S [the noninsured spouse]. Accordingly, the proceeds are not includible in D's [the insured spouse's] gross estate under §2042." *Cf. Estate of Burris v. Commissioner*, T.C. Memo 2001-210 (holding that policies owned by spouse who was also insured, as distinguished from policies owned by noninsured spouse, were community property under Louisiana law, such that only one-half of proceeds were includible in insured's estate under §2042(2)).

[338] *See, e.g., Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958).

[339] *See, e.g.,* DOL Advisory Opinions 90-46A, 90-47A (Wash. law); *see also* John R. Price & Samuel A. Donaldson, Contemporary Estate Planning (2016); William P. Streng, *Community Property in a Nutshell for ERISA Lawyers* (Conference Outline, ABA Tax Section, Employee Benefits Committee 1992).

[340] 937 F.2d 1450 (9th Cir. 1991).

[341] TAM 8943006.

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contrary opinion of the Supreme Court of Texas.[342] Agreeing with the 9th Circuit, the Supreme Court in *Boggs v. Boggs*,[343] held that Louisiana community property law was preempted by ERISA, with the effect that a deceased nonemployee spouse has no community property rights in his or her spouse's qualified plan, other than those provided by ERISA.[344]

2. Prior Law

Inclusion of commercial self-and-survivor annuities and life insurance annuities occurred long before the enactment of §2039. When the primary beneficiary was the first to die, inclusion of one-half of the value of the contract under the single predecessor to what are now §2035, §2036, and §2037 occurred, although the courts were sometimes vague as to the precise grounds of inclusion.[345] When the secondary beneficiary was the first to die, a 50% inclusion under §2033's predecessor occurred.[346]

The holding as to the primary beneficiary seems sound under the language of §2039. One must assume that the language of §2039(b), including "only such part of the value of the annuity … as is proportionate to that part of the purchase price therefor contributed by the decedent" will limit the inclusion when community funds or contributions occurring by reasons of employment of one of the spouses (in a community property jurisdiction) constitute the "purchase price."

This half-and-half inclusion was confirmed in Rev. Rul. 67-278,[347] although the ruling was published to deny the exemption of former §2039(c) when the wife predeceased the employee-husband, owning an interest in a "qualified" pension trust annuity. The exemption was available only for payments receivable by a beneficiary under a plan that was "qualified" at the time of "the decedent's separation from employment."

While perhaps correct at the verbal level, the principle had little else to commend it. It was repudiated by the enactment in 1972[348] of former §2039(d), exempting from taxation in a spouse's gross estate his or her community property interest in that portion of a "qualified" annuity that was attributable to employer contributions.

The Economic Recovery Tax Act of 1981 (ERTA)[349] amended former §2039(c) to provide that "[f]or purposes of this subsection, any deductible employee contributions (within the meaning of [§72(o)(5)]) shall be made by a person other than the decedent." It did not amend the next subsection — former §2039(d), Congress apparently believing that exemption under former §2039(c) meant exemption under former §2039(d). But the wholly-contributory qualified plan — that is, one to which the employer makes no contributions whatever — does exist. The exemption of former §2039(d) applied "in the case of an employee on whose behalf contributions or payments were made by his employer…." Deductible payments made to a wholly-contributory plan thus fell outside of the exclusion.

The individual retirement accounts (IRAs) authorized by §408 were subject to a comparable malady. There being no counterpart to former §2039(d) in the IRA provisions, the death of the non-employee spouse should result in inclusion of the value of his or her community interest in the retirement plan in his or her gross estate under §2033.[350]

The IRS was aware of the anomaly. In commenting on several proposed regulations in the annuity area, the IRS stated as follows:[351]

> Several persons commenting on the proposed regulations raised questions with regard to a decedent's community interest in an IRA.
>
> Section 2039 does not include rules specifically governing the treatment of community property interests in individual retirement plans. Community property interests are the subject of [former] §2039(d), but that section by its terms applies only to community property interests in a qualified employee plan or certain annuity contracts. Subject to certain conditions, if the non-employee spouse predeceases the employee spouse, the decedent spouse's community interest under a qualified plan or contract is excluded from the gross estate.
>
> Some commentators urged that the final regulations include a parallel rule for IRAs. The final regulations do not include such a broad rule. Absent statutory authority in [former] subsection (d) or (e) of §2039, a rule like that in [former] subsection (d) cannot be applied to the predeceased spouse's community interest in an individual retirement plan. This does not mean that the exclusion is therefore denied. The community interest of the predeceased spouse is excludible as described in [former] §2039(e), provided that the qualifying annuity rule in Reg. §20.2039-5(b) is satisfied with respect to that interest.

The statement quoted was less than satisfying as applied to treatment of rollover IRAs created out of qualified plan distributions.[352]

Most of these concerns became academic when Congress repealed the qualified-plan exemption in the Deficit Reduction Act of 1984 (DEFRA).[353] The repeal did not alter the rules regarding exclusion of the value of plan benefits in the event the nonworking spouse predeceases the employee spouse. To achieve this result, a redrafted former §2039(d) appeared as former §2039(c). The Tax Reform Act of 1986[354] repealed former §2039(c), as redesignated. Thus, there is no longer a spe-

[342] *See Allard v. Frech*, 754 S.W.2d 111 (1988) (Tex.); accord *Mundell v. Mundell*, 124 Idaho 152, 857 P.2d 631 (1993).
[343] 520 U.S. 833 (1997).
[344] *See* former §2039(c).
[345] *See Commissioner v. Estate of Wilder*, 118 F.2d 281 (5th Cir. 1941) (La. law).
[346] *See United States v. Stewart*, 270 F.2d 894 (9th Cir. 1959) (Cal. law).
[347] *Accord Estate of Bell v. United States*, 80-2 USTC ¶13,356 (E.D. Wash. 1980). Rev. Rul. 88-85 obsoleted Rev. Rul. 67-278 in part, to the extent the earlier ruling referenced repealed §2039(c), §2039(d), §2039(e), §2039(f), or §2039(g).
[348] Pub. L. No. 92-580, §2(a).
[349] Pub. L. No. 97-34, §311(d).
[350] PLR 8040101 (income tax ruling; probably involves La. law).
[351] T.D. 7761, 46 Fed. Reg. 7303 (Jan. 23, 1981).
[352] PLR 8040101 involved such an IRA. *See generally* Isidore Goodman, *Interest of Spouse in Employee Retirement Benefits* (1982).
[353] Pub. L. No. 98-369, §525(a).
[354] Pub. L. No. 99-514, §1852(e).

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cial exception for annuity interests created by community property laws.

H. Joint with Right of Survivorship Interests

1. General Rules

a. Current Law

Section 2040(b) provides a general rule of 50-50 estate inclusion of property that spouses hold as joint tenants with right of survivorship. The decedent's interest in such joint property is defined in §2040(b)(2) as a "qualified joint interest." Joint ownership of community property affects inclusion only in those instances when the spouses are not the only joint tenants (or where at least one spouse is not a U.S. citizen). In such cases, the consideration furnished rule of §2040(a) applies in determining the amount included in the decedent's gross estate.[355]

If the consideration furnished rule of §2040(a) applies, then there could be an issue regarding whether a spouse's community property interest in joint property was acquired for less than adequate and full consideration. In Rev. Rul. 55-605,[356] the IRS ruled that "one-half of the jointly owned property acquired with community funds" is includible in the gross estate of a wife when she predeceases her husband in a community property jurisdiction. The ruling deals with Nevada law — particularly in the interest of the wife under that law, and concludes that although under Nevada law the wife is unable to dispose of her interest in the community property in the event that she fails to survive her husband, she has a "vested" rather than an "expectant" interest in the community property. Under this ruling, the non-earner spouse is regarded as a co-contributor of the community property into joint ownership. The ruling appears to go further: in failing to inquire about the mode of the community property's creation, the ruling seems to concede that the conversion of separate property by agreement or conveyance into community property will result in inclusion only to the extent of the one-half community interest of whichever spouse is the first to die.

b. Prior Law

Prior to 1977, estate tax inclusion of property that spouses jointly owned depended on the source of the consideration for the property. Property that a decedent and their spouse inherited or acquired by gift was includible to the extent of half of its value.[357] Otherwise, the inclusion was measured by the proportion of the consideration that the decedent contributed.[358] For gift tax purposes, spouses were regarded as equal owners.[359]

In the Tax Reform Act of 1976,[360] Congress attempted to cure the anomaly by extending 50-50 inclusion to joint property created by taxable transfers between spouses in a transaction that was treated as a gift. The Revenue Act of 1978[361] further amended §2040 when it added a new section that allowed a surviving spouse to claim contribution by participation in a joint farm or business.[362] At this point, the results of the statute's application were almost wholly unpredictable. The Economic Recovery Tax Act of 1981 (ERTA)[363] repealed virtually all that had been added to §2040 since 1975, resulting in the current law, discussed above.[364]

2. Community Property Listed as a Qualified Joint Interest Under §2040(b) and Held as Survivorship Property Generally

The step-up in basis available under §1014(b)(6) should not be affected by listing the property as a qualified joint interest under §2040(b) if state law permits community property to be titled with right of survivorship.[365]

Community property held in survivorship title can create other issues. The Tax Court has ruled that, under California law, "property cannot be both joint tenancy and community property, as these two types of interests are mutually exclusive."[366] In *Estate of Young v. Commissioner*, the court characterized the real property interests that a resident alien couple owned as joint tenancy. The court did not find evidence rebutting the presumption the record title created, under which the couple held the parcels as joint tenants with right of survivorship. The court ruled that, in contrast to community property, the couple's joint tenancy property did not qualify for a fractional interest discount or lack of marketability discount in the husband's estate.[367]

In *Speier v. Brace*,[368] the husband filed for bankruptcy but the wife did not join in the petition. The couple had purchased property in 1977 or 1978 with community funds and titled as "joint tenants." If the property were considered community property, then it would all be reachable by the bankruptcy trustee, but if considered separate property, then only one-half of the property would be included in the bankruptcy estate. The court, after an extensive discussion about the interplay between community property and joint tenancy, held that the community property presumption controlled because "when a married couple uses community funds to acquire property with joint tenancy title on or after January 1, 1975, the property is presumptively community property … in a dispute between the couple and a bankruptcy trustee."[369]

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[355] §2056(d)(1)(B). See the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, §7815(d)(16), for a special rule concerning consideration furnished before July 14, 1988.

[356] Covering Nevada law.

[357] §2040(a) (last proviso).

[358] §2040(a).

[359] *See* V.B.4., below.

[360] Pub. L. No. 94-455, §2002, enacting former §2040(b).

[361] Pub. L. No. 95-600.

[362] Revenue Act of 1978, Pub. L. No. 95-600, §511(a), adding former §2040(c).

[363] Pub. L. No. 97-34, §403(c).

[364] The 2001 Act, Pub. L. No. 107-16, §542, as modified by the 2010 TRA, Pub. L. No. 111-312, §301, provided special rules relating to the ownership of jointly held property for 2010 decedents' estates electing to apply the modified carryover basis regime rather than paying the estate tax. For these estates, if the decedent jointly owned property and the only other owner was the surviving spouse, the decedent would be treated as owning 50% of the property. If the surviving spouse was not the only other owner, the decedent would be treated as owning the property to the extent of the consideration the decedent furnished to acquire the property or, if the decedent did not furnish consideration to acquire the property, to the extent of the value of a fractional portion of the property to be determined by dividing the property's value by the number of joint tenants. *See* §1022(d)(1)(B)(i).

[365] See III.F., above.

[366] *See Estate of Young v. Commissioner*, 110 T.C. 297, 300–301 (1998).

[367] *Estate of Young v. Commissioner*, 110 T.C. 297, 317.

[368] 470 P.3d 15 (Cal. 2020).

[369] *Speier v. Brace*, 470 P.3d 15 (Cal. 2020).

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3. Conversion of Joint Tenancy Community Property into Separate Property

The conversion of joint tenancy community property into equal amounts of separate property of the spouses normally results in no taxable transfer.[370] The Ninth Circuit had some difficulty in reaching this result,[371] finally achieving it in *Rickenberg v. Commissioner*,[372] on the theory that the husband's control-and-management power over community property is not an "interest in property," hence not the subject of a taxable transfer. A transfer in contemplation of death did occur in the *Rickenberg* case when pre-1927 California community property that the husband and wife held in joint tenancy was converted into a separate property tenancy in common. The court not only held that a "transfer" had occurred, but also that the wife's expectant interest was a "marital right," and hence not adequate and full consideration for that transfer.[373] Thus, the transfer would not escape estate tax.

4. Federal Preemption and Joint Tenancy Property

The federal preemption principle operates in the joint tenancy area as well. Thus, Treasury bonds purchased by one spouse with community funds and made payable to either husband "or" wife passed absolutely to the husband at the wife's death, although applicable local law required community property to pass to the wife's child from a former marriage.[374] Making the bonds payable to a third party would transfer the decedent's interest to the third party.[375] Unlike other federal preemption decisions, those in the "A-or-B" bonds cases do not purport to deprive the surviving spouse from half ownership without that spouse's consent.

I. Powers of Appointment

1. Regulation Reference to Unvested Interests

In a rare reference to community property matters, the estate tax regulations provide as follows: "If the community property laws of a State confer upon the wife a power of testamentary disposition over property in which she does not have a vested interest she is considered as having a power of appointment."[376] This provision is clearly outdated and presumably refers to very early positions, later refuted,[377] that a wife's community property interest was not vested because of the husband's exclusive management power that existed in the community property states until the 1970s. Whether a power, if general and held at death, results in estate tax inclusion depends upon the date of its creation. The regulation does not specify when the creation of such statutory power occurs. In a given case, the crucial date might be the date of enactment of the statute conferring the power, the date of the marriage, the date upon which the married couple became domiciled in the community property state, the date at which the particular property transferred was originally acquired, or the effective date of an agreement converting separate property into community property. The regulation speaks only of a "power of appointment" and does not foreclose the possibility that such a statutory power may not result in the estate tax applying because it falls outside the definition of "general power of appointment."[378] The regulation seems aimed at California community property acquired between August 17, 1923, and July 29, 1927.[379] Because both spouses' interests in community property are now recognized as equal and vested, the provision has no relevance today.

2. Powers That Previously were Conferred upon the Community Manager

Practice Tip: In all trusts of community property and particularly in surviving spouse's election situations, the planner must take special care to avoid accidentally conferring a general power of appointment.

This occurred in one case involving a joint-and-mutual will, which resulted in the entire value of the community property being included in the surviving spouse's estate.[380] The same result would have occurred in the famous *Estate of Vardell v. Commissioner*[381] case, save for the fact that the wife's election occurred prior to October 21, 1942; during that time, a general power resulted in tax only if exercised — a circumstance that did not occur in the case.

Katz v. United States,[382] indicates that it may have been impossible to confer upon a community manager a general power of appointment in the spouse's half of the community property that was exercisable during their joint lives. In that case, the manager made a transfer of community property in trust, retaining a power "to revoke, terminate or amend." In the court's view, the manager held the power as agent for the community. Finding that "it is no more a general power of appointment than the power he had over the community property before the trust was created," and that "it was never held that those powers amount to a general power of appointment over the wife's interest," the court rejected the IRS's argument.

If, as is the case under joint-management statutes, either spouse can transfer community property into a revocable trust without the consent of the other, and thereby cause half of the trust principal to be included in the other's estate, then symmetry in this area of the law would appear to demand the result in the *Katz* case in respect of powers exercisable during the joint lives of the spouses.

In *Albuquerque Nat'l Bank v. United States*,[383] the Tenth Circuit dealt with what began as a revocable inter vivos trust of community property. At the death of the husband, the trust

[370] *See Rickenberg v. Commissioner*, 177 F.2d 114 (9th Cir. 1949) (regarding California law).

[371] *See Estate of Sullivan v. Commissioner*, 175 F.2d 657 (9th Cir. 1949) (regarding California law).

[372] 177 F.2d 114 (9th Cir. 1949).

[373] *See* §2035(a).

[374] *See Yiatchos v. Yiatchos*, 376 U.S. 306 (1964) (regarding Washington law).

[375] *See Free v. Bland*, 369 U.S. 663 (1962) (regarding Texas law).

[376] Reg. §20.2041-1(b)(1) (fourth sentence).

[377] *See Warburton v. White*, 176 U.S. 484 (1900).

[378] *See* Reg. §20.2041-1(c).

[379] *See* Maxwell E. Foster, California Will Drafting §3.7 (1965).

[380] *Phinney v. Kay*, 275 F.2d 776 (5th Cir. 1960) (Tex. law); *accord Lehman v. United States*, 448 F.2d 1318 (5th Cir. 1971) (Tex. law); *Estate of Witkowski v. United States*, 451 F.2d 1249 (5th Cir. 1971) (Tex. law).

[381] 307 F.2d 688 (5th Cir. 1962) (Tex. Law; dissenting opinion of Judge Wisdom).

[382] 382 F.2d 723 (9th Cir. 1967) (Cal. law).

[383] 80-1 USTC ¶13,329 (10th Cir. 1979), rev'g and rem'g 443 F. Supp. 742 (D.N.M. 1978).

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became irrevocable. The trust instrument conferred upon the surviving wife the power "to alter and change" the dispositive provisions "as to not more than one-half the Trust Estate." The trust instrument provided elsewhere that "the trustee shall pay the debts of the last settlor to die." At the wife's death, the government asserted that she had a general power of appointment over the trust assets. Noting that "[t]he reliance by the Government on the direction to pay debts as a general instruction to overcome the express limitation is not persuasive," the court held that the wife did not have a general power of appointment.[384]

Estate of Steinman v. Commissioner,[385] also involved the death of a surviving spouse — this time in a surviving spouse's election situation. There, the husband executed a will in which he created two trusts, the first of which, denominated the "Bluma Steinman Trust," was designed as a marital deduction trust of the life estate-general power variety.[386] In addition to the bequest of the usual "one-half of my adjusted gross estate," the husband bequeathed "[p]roperty of a value equal to my wife's portion of our community property less the value of our community property passing to her, whether under this will (except pursuant to this article) or otherwise." The wife "elected to take under [the husband's] will rather than take her statutory community share" at the time of the execution of the will. The husband died in 1954. The case arose after the death of the wife in 1970. The wife's estate argued that the amount includable in her estate should be reduced by the value of what she gave up for the election pursuant to §2036.

The Tax Court rejected this, flatly stating that "the section causing the inclusion of the corpus of the Bluma Steinman Trust in decedent's gross estate is not section 2036, but section 2041." It concluded that the entire Bluma Steinman Trust was includible under §2041 and, citing a somewhat questionable 1973 Tax Court decision[387] for a proposition for which it is unlikely that it stands,[388] concluded that no reduction was available because the inclusion had occurred under §2041.

J. Life Insurance

The includibility in the insured's gross estate of the proceeds from life insurance policies on his or her life is governed primarily by §2042. Inclusion may be required under certain other sections, particularly §2035.[389] The includibility in a noninsured spouse's estate of an interest in a policy on the life of the surviving spouse (or another person) is determined mainly by §2033. However, in some circumstances, an interest may be includible under §2035–§2038 or §2041. Under §2033, a noninsured spouse's estate includes one-half of the community property interest and the full value of his or her separate property interest in a policy on the life of the insured spouse.[390] For a more detailed discussion on life insurance, see 826 T.M., *Life Insurance*.

1. Life Insurance Proceeds Receivable by the Executor — §2042(1)

Under §2042(1), a decedent's estate includes the proceeds of policies of insurance on the life of the decedent that are "receivable by the executor." The rule extends to the proceeds of insurance paid to the insured's personal representative and to proceeds paid to another beneficiary subject to a legally binding obligation "to pay taxes, debts, or other charges enforceable against the [insured's] estate."[391] Proceeds paid to the estate of the insured are not includible if state law requires them to be paid to the insured's surviving spouse or children.[392]

Importantly, the regulations make it clear that the noninsured spouse's interest in the proceeds of a community property policy that are paid to the insured's "estate" is not includible in the insured's gross estate.[393] In particular, Reg. §20.2042-1(b)(2) provides that:

> If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belong to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

Consistently, if the spouse of the insured dies before the insured, only one-half of the value of the community property interest in each policy on the life of the insured spouse is includible in the noninsured spouse's gross estate.[394] The interest is includible in the noninsured spouse's estate by reason of §2033, not §2042.

The Fifth Circuit, applying Texas law, has held that 100% of the proceeds of insurance policies on the life of a decedent spouse, which named his estate as beneficiary, were includible in his gross estate under §2042(1), notwithstanding the fact that the premiums had been paid with community funds.[395] The decedent had "substantially provided" for the surviving spouse

[384] *Albuquerque Nat'l Bank v. United States*, 80-1 USTC ¶13,329 (10th Cir. 1979), rev'g and rem'g 443 F. Supp. 742 (D.N.M. 1978).

[385] 69 T.C. 804 (1978).

[386] *See* §2056(b)(5).

[387] *Estate of Frothingham v. Commissioner*, 60 T.C. 211 (1973).

[388] The result in *Frothingham* is supportable on the rationale that the power was created by a prior decedent via a will contest settlement. *Cf.* Reg. §20.2056(c)-2(d)(2) (property acquired by surviving spouse in will contest "passed from the decedent to his surviving spouse").

[389] Under §2035(a), the insured's gross estate includes the insured's interest in life insurance policies that the insured transferred within a three-year period immediately preceding the insured's death.

[390] *E.g., Estate of Marks v. Commissioner*, 94 T.C. 720 (1990) (La. law).

[391] Reg. §20.2042-1(b)(1). In *Bintliff v. United States*, 462 F.2d 403 (5th Cir. 1972), a portion of the proceeds of a policy that was entirely owned by the noninsured spouse was used to discharge a community debt. For that reason, one-half of the proceeds so applied was included in the gross estate of the deceased insured under §2042(1). The policy had been pledged by the insured and noninsured spouses as security for a community property debt. When the insured died, the proceeds were applied, in part, to satisfy the debt. According to the court, "It is the estate that has benefited from the use of the proceeds to satisfy a community debt." 462 F.2d at 408.

[392] *Webster v. Commissioner*, 120 F.2d 514 (5th Cir. 1941) (Fla. law).

[393] *See* John C. Huston, *Transfers to the 'Estate' of a Named Person*, 15 Syracuse L. Rev. 463 (1964), *reprinted in* 14 Tax Counselors Q. 270, and 2 *Landmark Papers in Estate Planning, Wills, Estates and Trusts* 622 (Winard ed., 1968).

[394] *E.g., United States v. Stewart*, 270 F.2d 894 (9th Cir. 1959) (Cal. law; 1939 Code). In *Stewart*, the court held that "at the time of the wife's death she had present, existing and equal interests with her husband in the policies; that these interests amounted to ownership of one-half of whatever value the policies had at the time of her death, and that such an amount must be included in her gross estate." 270 F.2d at 902. *See also Scott v. Commissioner*, 374 F.2d 154 (9th Cir. 1967) (Cal. law).

[395] *Estate of Street v. Commissioner*, 152 F.3d 482 (5th Cir. 1998).

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in a surviving spouse's election will, but she had elected not to take under the will, claiming instead her one-half interest in the community property.[396] Affirming the Tax Court ruling that the decedent's designation of his estate as beneficiary and subsequent death had removed the insurance proceeds from the regime of community property (a decision that had been strongly criticized by a prominent commentator),[397] the court held that "there can be no contention that the entire amount of the insurance proceeds in the case was not properly included in [the decedent's] gross estate for federal estate tax purposes."[398]

2. *Life Insurance Proceeds Receivable by Other Beneficiaries — §2042(2)*

The proceeds of life insurance policies receivable by beneficiaries other than the insured's personal representative are includible in the insured's gross estate under §2042(2) to the extent the insured held any incidents of ownership in the policies at the time of his or her death, exercisable alone or in conjunction with any other person. The term "incidents of ownership" is not defined in the Code, but Reg. §20.2042-1(c)(2) describes the type of interests that are treated as incidents of ownership for purposes of §2042(2):

> [T]he term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

In 1937, the Supreme Court held that where the local law treats each spouse as holding a one-half interest in policies of insurance that are acquired with community property, only one-half of the proceeds is includible in the insured spouse's gross estate.[399] The holding is reflected in the following passage from Reg. §20.2042-1(c)(5), which recognizes that an insured spouse holds incidents of ownership in a policy only to the extent the insured is treated as owning an interest in the policy under the local community property law:

> As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an "incident of ownership," and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.

Section 2042(2) was held to require inclusion of only half of the proceeds of life insurance policies under the following circumstances: a Texas couple had purchased three policies on the husband's life using community funds, and upon the wife's death intestate, predeceasing the husband, her one-half interest passed to the couple's children. The children did not exercise their right to receive one-half of the cash surrender value of the policies, which remained in effect. Following the husband's death, his estate included one-half of the proceeds, as well as accounts receivable from the children as reimbursement for the premiums paid by the husband following the wife's death. The Tax Court had ruled that the husband's gross estate included 100% of the proceeds, accepting the Commissioner's argument that the wife's interest in the policies was settled when one-half of the cash surrender value of the policies was allocated to her estate and reported on her federal estate tax return. Distinguishing between "policy rights" and "proceeds right" under Texas law, the Fifth Circuit reversed, finding that the wife's interest had never been "settled," and that the husband's estate owned only one-half of the policy rights, because ownership of the wife's one-half interest in the policy rights had earlier passed to the children. The court also permitted recovery of the estate's reasonable litigation costs against the Commissioner.[400]

3. *Imputed Incidents of Ownership — Reg. §20.2042-1(c)(6)*

If all of the stock of a corporation is owned by a couple as their community property, the incidents of ownership in policies insuring their lives that are owned by the corporation and payable to beneficiaries other than the corporation should not be attributed to either of them. Under Reg. §20.2042-1(c)(6), the sole or controlling shareholder of a corporation is treated as holding incidents of ownership in policies owned by the corporation that insure the shareholder's life (other than §79 group-term policies) to the extent the proceeds of the policies are not payable to or for the benefit of the corporation. This approach assumes that the value of policies payable to or for the benefit of the corporation will be reflected in valuing the stock of the corporation under §2031. Under the regulation, "the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock processing more than 50 percent of the total combined voting

[396] *Estate of Street*, 152 F.3d 482, 483.

[397] *Estate of Street*, 152 F.3d 482, 483, n. 1 (quoting Prof. Stanley M. Johanson, who had criticized the Tax Court ruling in the following terms: "This decision is not only wrong, it's outrageous!" in Stanley M. Johanson, *Recent Decisions Affecting Estate Planning*, Univ. of Tex. Sch. of Law 45th Ann. Tax'n Conf. 35 (1997)).

[398] *Estate of Street v. Commissioner*, 152 F.3d 482, 485 (5th Cir. 1998).

[399] *Lang v. United States*, 304 U.S. 264 (1937) (Wash. law). *See also* Rev. Rul. 53-48 (Tex. and La. law), *modified by* Rev. Rul. 75-100 (Tex. law), *revoked by* Rev. Rul. 94-69 (La. Law).

[400] *Estate of Cervin v. Commissioner*, 111 F.3d 1252 (5th Cir. 1997).

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power of the corporation." The subsequent text of the regulation indicates that the ownership of jointly owned stock will be imputed from one shareholder to the other only to the extent required by §2040. In particular, each shareholder will be considered to hold only so many of the shares that are jointly held by the decedent and others as would be "considered to be furnished by the decedent for purposes of §2040." Accordingly, under the regulation a decedent could only be treated as owning his or her one-half interest in community property stock — and none of the other spouse's share. The propriety of treating each spouse as the owner of only his or her one-half interest in community property stock is supported by the approach taken in valuation cases involving community property. Under those cases, each spouse is considered to own an undivided one-half interest in community property shares of stock.[401] Accordingly, neither spouse could hold a controlling interest in a corporation whose shares are all owned by the spouses as their community property. Indeed, under the current version of §2040,[402] presumably the same result would be reached where all of the stock is held by a both spouses as joint tenants with right of survivorship.

4. *Inclusion in Gross Estate of Noninsured Spouse Who Predeceases Insured — §2033*

In an early ruling, the Commissioner ruled that if a noninsured spouse predeceased the insured spouse, one-half of the value of the community property interest in the policy is includible in the noninsured spouse's gross estate "as her interest in a community asset or as a revocable transfer under §2038 of the Code."[403] The courts accepted this approach, under which the noninsured spouse's estate is required to include one-half of the value of community property policies on the life of the surviving spouse.[404] Where the noninsured spouse dies owning a policy on the life of the surviving spouse as his or her separate property, the entire value of the policy is includible in the survivor's estate under §2033. As indicated in IV.J.7.d., below, the value of the noninsured spouse's community property interest in a term policy is generally limited to one-half of the unearned premium for the period following the noninsured spouse's death.

5. *Inclusion of Proceeds of Policy in Gross Estate of Noninsured Spouse Who Survives Insured — §2033, §2036, §2037, §2038, §2041*

If the insured spouse dies before the noninsured spouse, then the proceeds paid to the surviving spouse are, of course, subject to later inclusion in the surviving spouse's estate (to the extent not consumed) under §2033[405] and potentially under other sections.

If spouses transfer a community property policy of insurance on the life of one spouse to an inter vivos trust, each spouse is considered to be the grantor to the extent of his or her interest in the policy.[406] If the noninsured spouse-grantor retains a life interest in the trust, one-half of the community property interest in the policy (or its proceeds) is includible in his or her gross estate under §2036.[407] Inclusion might also be required under §2037 or §2038 if the noninsured spouse held interests in the trust that would trigger the application of one of those provisions.

Under §2041, the surviving spouse's estate must include the proceeds of policies that were retained by the insurer pursuant to the insured spouse's election which allowed the surviving spouse to withdraw the proceeds at any time.[408]

6. *Inclusion of Proceeds of Policy Transferred by Insured Within Three Years of Death — §2035*

The general rules regarding the inclusion of property transferred by a decedent within the three-year period immediately preceding death are reviewed at IV.E., above.

Under §2035(a),[409] if:

(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the three-year period ending on the date of the decedent's death, and

(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under §2036, §2037, §2038, or §2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Accordingly, the insured's estate is required to include one-half of the proceeds of the community property interest in policies that an insured spouse transfers within three years of death. Inclusion is required under §2035(a) because the proceeds would have been included to that extent under §2042 if such interest "had been retained by the decedent."

Funds that are gratuitously transferred by a donor within three years of death are generally not includible in the donor's estate regardless of the manner in which the funds are expended by the donee. Similarly, funds that are applied by the donor

[401] *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982) (Ariz. law, real property); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (Tex. law); *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978) (Wash. law), nonacq., 1980-1 C.B. 2, acq., Rev. Rul. 93-12.

[402] ERTA, Pub. L. No. 97-34, §403(c).

[403] Rev. Rul. 53-48 (Tex. and La. law), *revoked by* Rev. Rul. 94-69; *see also* Rev. Rul. 53-232 (La. law), *revoked by* Rev. Rul. 94-69; Rev. Rul. 2003-40.

[404] *Scott v. Commissioner*, 374 F.2d 154 (9th Cir. 1967) (Cal. law); *United States v. Stewart*, 270 F.2d 894 (9th Cir. 1959) (Cal. law).

[405] *Estate of Marks v. Commissioner*, 94 T.C. 720 (1990) (La. law).

[406] *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969). Note, however, that two poorly reasoned decisions allow insurance proceeds received by a trust to be excluded from the gross estate of a deceased life beneficiary of the trust who had paid premiums on the policies. *Nat'l City Bank of Cleveland v. United States*, 371 F.2d 13 (6th Cir. 1966); *Goodnow v. United States*, 302 F.2d 516 (Ct. Cl. 1962).

[407] *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969). In *Gordon*, the court treated the noninsured spouse as the trust's grantor to the extent of her community property interest in the policy on her husband's life. Although that interest was includible in her gross estate, the court allowed her estate a consideration offset under §2043(a), which reduced the amount includible in her gross estate by the life estate's actuarial value she received in the share of the insurance proceeds her husband transferred to the trust.

[408] *Estate of Towle v. Commissioner*, 54 T.C. 368 (1970). However, an unexercised pre-1942 power to withdraw the proceeds of a life insurance policy does not require them to be included in the estate of the holder of the power. *United States v. Turner*, 287 F.2d 821 (8th Cir. 1961).

[409] Pub. L. No. 105-34, §1310.

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within three years of death to pay premiums on policies that insure the donor's life are generally not included in the insured donor's gross estate. The appellate courts have uniformly held that the proceeds of policies purchased by a donee within three years of the donor's death with funds provided by the donor are not includible in the donor's gross estate under §2035.[410] The position taken by the courts reflects a hypertechnical view, which Congress may not have intended.

The result appellate courts have reached under post-1982 law is contrary to the outcome of many cases decided under the pre-1982 provisions of §2035.[411] The pre-1982 cases often treated the insured as the transferor of policies that were acquired by a trustee or other transferee within three years of the insured's death with funds provided by the insured.[412] In those cases, the courts sometimes characterized such gifts of funds as "beamed transfers" in which the insured in substance transferred the policies themselves and not merely the funds that were used to acquire the policies.[413] On the other hand, the insured's estate was commonly not required to include the proceeds of policies that were acquired by an independent party within three years of the insured's death with funds that the donee was free to invest as he or she chose.[414]

[410] *Estate of Perry v. Commissioner*, 927 F.2d 209 (5th Cir. 1991); *Estate of Headrick v. Commissioner*, 918 F.2d 1263 (6th Cir. 1990); *Estate of Leder v. Commissioner*, 893 F.2d 237 (10th Cir. 1989). Indeed, in a subsequent opinion in *Perry*, the court awarded attorney's fees of $9,206 to the taxpayer for the appeal's legal costs, which the court stated was not "substantially justified." *Estate of Perry v. Commissioner*, 931 F.2d 1044 (5th Cir. 1991). According to the court, the IRS was continuing "to whip a dead horse in circuit after circuit." 931 F.2d at 1046. In AOD CC-1991-012, issued January 18, 1991, the IRS announced that it would no longer contest the issue: "Although we continue to believe that substance should prevail over form and that such indirect transfers should be included in a decedent's gross estate, in light of the three adverse appellate opinions set forth above, we will no longer litigate this issue."

[411] Before 1982, interests in life insurance policies and the proceeds of policies on the insured's life were generally subject to the basic rules of §2035. Former §2035(b) was amended by the Tax Reform Act of 1976 (1976 TRA), Pub. L. No. 94-455, §2001(a)(5), to eliminate the need to include gifts made within three years of death for which the decedent was not required to file a gift tax return. The exclusion was later narrowed because of the risk that it might allow the exclusion of the proceeds of insurance policies that were transferred by a decedent within three years of death. Effective for decedents dying after December 31, 1976, former §2035(b)(2) was amended to provide that the exclusion "shall not apply to any transfer with respect to a life insurance policy." In several cases arising under the law after the enactment of the 1976 TRA and prior to ERTA's enactment in 1982, the courts held that one-half of the proceeds of a policy were includible in the estate of a decedent who "arranged for the policy, partially paid for it with his share of community funds, which he gifts to his wife for the specific purpose of paying the premiums and died within three years after the policy came into force." *Knisley v. United States*, 901 F.2d 793, 795 (9th Cir. 1990); *Estate of Schnack v. Commissioner*, 848 F.2d 933 (9th Cir. 1988); *Lester v. United States*, 947 F.2d 950 (9th Cir. 1991). The approach was changed again by ERTA, Pub. L. No. 97-34, §424. *See* former §2035(d)(2). ERTA added former §2035(d)(1), which reversed the basic inclusionary rule for decedents dying after 1981, and former §2035(d)(2), which required inclusion of certain transfers made within three years of death, including transfers of policies of insurance that would have been included under §2042 had the transfer not been made. The 1997 Act, Pub. L. No. 105-34, §1310, restructured §2035, incorporating the concepts of former §2035(d) into §2035(a). For further discussion of §2035, see 818 T.M., *Section 2035 Transfers.*

[412] *E.g., First Nat'l Bank of Or. v. United States*, 488 F.2d 575 (9th Cir. 1973); *Detroit Bank & Tr. Co. v. United States*, 467 F.2d 964 (6th Cir. 1972) (1973).

[413] *Bel v. United States*, 452 F.2d 683, 691 (5th Cir. 1971) ("We think our focus should be on the control beam of the word 'transfer.' The decedent, and the decedent alone, beamed that accidental death policy at his children….").

[414] *E.g., Hope v. United States*, 691 F.2d 786 (5th Cir. 1982).

7. *Characterization of Interests in Life Insurance Policies and Proceeds Under Local Law*

a. *In General*

With the exception of life insurance policies issued in connection with military service,[415] the extent of a deceased spouse's interests in life insurance policies is fixed by local law. In the absence of a contrary agreement between spouses, the ownership interests in policies on the life of a married person are determined according to state law. When both separate and community property have been used to pay premiums over the life of a whole life policy, the states adhere generally to one of two theories. Under one, the so-called apportionment theory, the interests of the spouses are determined according to the origin of the funds used to make premium payments.[416] In contrast, the inception-of-title theory characterizes policies according to the status of the policy at the time it was originally acquired.[417] Accordingly, a policy that was originally acquired with the separate property of the insured spouse would be owned by the insured as his or her separate property regardless of the extent to which subsequent premiums were paid from community property. Instead, the community would be entitled to reimbursement for the premiums on the separate property policy that had been paid with community property funds. For term life policies, most community property states apply the risk payment theory, which characterizes the proceeds based on the character of the last premium paid.[418]

b. *Cross-Owned Policies and the Reciprocal Trust Doctrine*

In Rev. Rul. 67-228,[419] the IRS applied a version of the reciprocal trust doctrine[420] to the purchase by each spouse of a policy of insurance on the life of the other spouse. The ruling concluded that:

> [W]here substantially identical policies of life insurance are purchased concurrently with community funds by a Texas husband and wife, each naming the other as policy owner and beneficiary, the presumption under Texas law that the policies are community property will prevail unless it is clearly shown that the transfers were not reciprocal and that gifts were intended. Accordingly, as a community asset, one-half of the value of the property received as insurance on the life of the husband upon his death is includible in his gross estate under the provisions of section 2042 of the Code. Furthermore, one-half of the value of the policy on the life of the wife is includible in his gross estate under section 2033 of the Code as his interest in the community asset.

[415] At various times, federal law has provided life insurance coverage for armed services' members and veterans that gave the insured the right to designate the beneficiary, and federal law may preempt state community property laws. *See Wissner v. Wissner*, 338 U.S. 655 (1950).

[416] *E.g., Blethen v. Pac. Mut. Life Ins. Co. of Cal.*, 243 P. 431 (Cal. 1926).

[417] *E.g., McCurdy v. McCurdy*, 372 S.W.2d 381 (Tex. Civ. App. 1963).

[418] *E.g., Aetna Life Ins. Co. v. Wadsworth*, 689 P.2d 46 (Wash. 1984).

[419] Covering Texas law.

[420] For an explanation and application of the doctrine, *see United States v. Estate of Grace*, 395 U.S. 316 (1969).

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Apparently, the reciprocal trust argument was not made in *Estate of Marks v. Commissioner*,[421] in which the Tax Court concluded that under Louisiana law, each spouse was considered to own the entire interest in a policy on the life of the other spouse. Each noninsured spouse applied for the policy on the life of the other and was designated as its owner. Each policy contained a clause giving the designated owner full control over it. In an earlier case arising under California law, the government raised the reciprocal trust doctrine in its opening statement, but failed to brief it and was considered by the Tax Court to have abandoned it.[422] It is questionable whether it would be appropriate to apply the reciprocal trust doctrine to a couple's run-of-the-mill purchase of cross-owned policies of life insurance.

c. Agreements Regarding Status of Property

The community property states generally allow spouses to agree between themselves regarding the character and extent of their respective ownership interests in property, including life insurance policies. Accordingly, spouses may agree that a policy on the life of one spouse will be the separate property of the other spouse although the premiums are all paid from community property.

Practice Tip: Of course, in such a case each premium payment would involve a gift by the insured spouse to the noninsured spouse of one-half of the premium.

The courts have generally required clear and convincing evidence of such an agreement to overcome the generally applicable presumption that property acquired during marriage is community property. In some instances, courts have held that the designation in the insurance application or in the policy of the noninsured spouse as owner supplemented by evidence of oral statements by the insured spouse was sufficient to overcome the presumption.[423] In others, the courts have required greater proof of the contemporaneous intent of the spouses that the policy be the separate property of the noninsured spouse — a printed provision on an insurance application form may be insufficient.[424]

d. Apportionment Theory

Under the apportionment theory, which is followed in California[425] and Washington,[426] and may apply in Idaho or Nevada, the ownership of a cash value life insurance policy is apportioned between the separate and community interests of the spouses according to the source of the funds used to pay the premiums.

> *Example:* Husband (H) domiciled in California paid two $1,000 premiums on a policy on his life prior to marriage and three annual $1,000 premiums from community property following his marriage. H would own a two-fifths interest in the policy as his separate property and a three-tenths interest as his one-half interest in the community property share of three-fifths. H's Wife (W) would own the other three-tenths interest as her one-half share of the community property interest in the policy. H would be entitled to designate the beneficiary of seven-tenths of the proceeds (two-fifths plus three-tenths) and W would be entitled to control the disposition of the other three-tenths interest.

As indicated by *Scott v. Commissioner*,[427] a noninsured spouse who predeceases the insured spouse is entitled to dispose of his or her interest in the policy as he or she wishes. If the noninsured spouse leaves his or her interest in the policy to a person other than his or her insured surviving spouse, the beneficiary and the insured henceforth own the policy as tenants in common. As in *Scott*, the ownership interests of the tenants in common would change if future premium payments are not all made in proportion to the tenants' ownership interests in the policy. Thus, in the example described above, the interests of the noninsured spouse's successor would increase if the successor paid more than three-tenths of the subsequent premiums on the policy. Conversely, the insured spouse's interest would increase and the co-tenant's interest would diminish if the insured spouse paid more than seven-tenths of the future premiums.

e. Inception-of-Title Theory

Under the inception-of-title theory, which is generally followed in Arizona, Louisiana, New Mexico, and Texas, the ownership of a whole life policy is fixed at the time of its original acquisition.[428] Thus, a policy purchased by an individual pri-

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[421] 94 T.C. 720 (1990) (La. law).

[422] *Estate of Wilmot v. Commissioner*, T.C. Memo 1970-240 (Cal. law).

[423] *Kroloff v. United States*, 487 F.2d 334 (9th Cir. 1973) (Ariz. law; designation of husband as owner and oral evidence of intent that policy on wife's life be husband's separate property was sufficient to establish husband's ownership of policy); *Catalano v. United States*, 429 F.2d 1058 (5th Cir. 1969) (La. law; policy was wife's separate property where husband returned policy to insurer with request that it be corrected to list wife as owner with "all options, privileges, values and benefits"); *Parson v. United States*, 460 F.2d 228 (5th Cir. 1972) (Tex. law; written designation of noninsured spouse as owner was sufficient to establish separate character of policy); *Estate of Saia v. Commissioner*, 61 T.C. 515 (1974) (La. law; following *Catalano*, designation of husband as owner and beneficiary of policy on wife's life was sufficient to establish it as his separate property), *nonacq.*, 1978-2 C.B. 4. In an AOD issued on August 7, 1970, the IRS announced that it considered the *Catalano* result determinative "in all Louisiana cases involving the issue (where the wife is named owner or irrevocable beneficiary)." AOD, *Parson v. United States*, 308 F. Supp. 1159 (E.D. Tex. 1970), aff'd in part, rev'd in part, 460 F.2d 228 (5th Cir. 1972).

[424] *Freedman v. United States*, 382 F.2d 742 (5th Cir. 1967) (Tex. law; listing husband as owner on printed form was insufficient to establish wife's intent that husband should own the policy on her life as his separate property); *Kern v. United States*, 491 F.2d 436 (9th Cir. 1974) (Wash. law; designation as owner on printed form was insufficient, but separate typewritten endorsement showing noninsured spouse as owner of a second policy was sufficient to establish its separate character). Note, however, that a U.S. district court later held that an oral agreement between a husband and wife that each party's earnings would be his or her separate property was valid under Washington law and would be recognized for federal tax purposes. *Venie v. United States*, 88-1 USTC ¶9106 (E.D. Wash. 1987).

[425] *See, e.g., Biltoft v. Wootten*, 96 Cal. App. 3d 58, 157 Cal. Rptr. 581 (1979); *Modern Woodman of Am. v. Gray*, 113 Cal. App. 729, 299 P. 754 (1931).

[426] *See, e.g., Porter v. Porter*, 726 P.2d 459 (Wash. 1986) (apportionment rule applies except for term life policies).

[427] 374 F.2d 154 (9th Cir. 1967) (Cal. law).

[428] Rev. Rul. 53-232 analyzed Louisiana law and described the federal estate and gift tax consequences where policies were acquired by a married person at various times with various types of property for decedents dying before May 15, 1995 owning policies acquired before November 14, 1994. The ruling was followed in Rev. Rul. 54-272 for the characterization under Texas law of a policy acquired during marriage where the initial premium was paid with the insured's separate property, but subsequent premiums were paid with community property funds. Rev. Rul. 94-69, following *Catalano v. United States*, 429

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or to marriage is that person's separate property, even though some subsequent premiums are paid from community property. The same is true if a policy is purchased during marriage with the separate funds of one spouse — the policy is the separate property of that spouse unless by making the premium payment he or she intended to make a gift to the other spouse of a one-half interest in the funds. If the policy is the separate property of the insured spouse, upon his or her death the community is generally entitled to be reimbursed for any premiums that were paid with community property funds. The obligation to make the reimbursement reduces the amount subject to inclusion in the decedent's estate under §2042.[429]

If the noninsured spouse dies before the insured spouse, under §2033, the noninsured spouse's estate includes an amount equal to one-half of the value of the community property interest in the policy. The noninsured spouse's estate is entitled to recover that amount from the insured spouse. Thereafter, under Texas law, the insured spouse is entitled to dispose of the property as he or she wishes — when the insured dies the entire proceeds are includible in the insured's estate for federal estate tax purposes.[430] However, if the insured spouse dies before making reimbursement to the noninsured spouse's estate, the noninsured spouse's estate or its distributees are entitled to one-half of the amount of the proceeds attributable to the community property interest in the policy.[431]

A number of decisions have considered the includibility of life insurance in the gross estate under the community property laws of the various "inception-of-title" states. Louisiana law was applied in the life insurance context in *Estate of Burris v. Commissioner*.[432] *Burris* held that policies on a husband's life were presumptively community property as a matter of Louisiana law when the husband was named as owner of the policy. The court held that only half of the policy proceeds were includible in the husband's estate under §2042(2). The husband had used community funds to purchase three single-premium policies. The husband was named as owner of the policies, and the wife was named as the initial beneficiary. Following the wife's death, her estate tax return included one-half of the cash surrender value of the policies. After her death, the husband substituted the couple's children as beneficiaries. The IRS argued that under Louisiana decisions the policies were the husband's separate property and 100% of the proceeds was includible in his gross estate under §2042(2). Distinguishing the Fifth Circuit's decision in *Catalano v. United States*[433] as applying when one spouse is designated as the owner or irrevocable beneficiary of a policy on the life of the other spouse, the court noted that the *Burris* scenario involved one spouse being both the insured and the named owner. The court noted that Louisiana courts had repeatedly distinguished between ownership of policies, which the courts had held is governed by community property principles, and ownership of proceeds, which the courts have held is not. Emphasizing that the IRS's own regulatory test for inclusion under §2042(2) turns on who possesses incidents of ownership in the policy rather than in the proceeds, the court ruled that the three policies were presumed to be community property under Louisiana law, and accordingly, that only one-half of the proceeds was includible in the husband's gross estate. The IRS acquiesced in the *Burris* result.[434]

Louisiana law relating to life insurance policies was also the subject of two revenue rulings. Rev. Rul. 94-69 concerned a decedent, domiciled in Louisiana, who had purchased a life insurance policy on the decedent's own life, designating the decedent's spouse as owner of the policy, thereby conferring on the spouse all incidents of ownership. The spouses paid all premiums using community funds. Citing the interpretation of Louisiana law by the Fifth Circuit in *Catalano* and the Tax Court in *Estate of Saia v. Commissioner*,[435] the IRS ruled that when a Louisiana domiciliary decedent purchases an insurance policy on the decedent's own life during marriage, names the decedent's spouse as the policy owner, and pays all of the premiums from community funds, none of the insurance proceeds are includible in the decedent's estate under §2042(2).

Rev. Rul. 2003-40 also considered the inclusion under §2042(2) of a policy purchased by a Louisiana decedent, des-

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F.2d 1058 (5th Cir. 1969), revoked Rev. Rul. 53-232 effective for decedents dying after May 14, 1994 owning policies acquired before November 14, 1994. In PLR 8928003, the IRS ruled that a policy was community property and only one-half of the proceeds were includible in the insured husband's estate, where husband had applied for the policy, used community property funds to acquire it, and was listed in the policy as the owner. It is, in effect, the converse of *Catalano* and *Estate of Saia v. Commissioner*, 61 T.C. 515 (1974). *See Estate of Street v. Commissioner*, T.C. Memo 1997-32 (where entire amount of insurance on Texas decedent's life that became separate property when he named his estate as beneficiary was held includible in decedent's gross estate under §2042). The Fifth Circuit, affirming on slightly different grounds, held that the entire insurance policy proceeds were includible in the decedent's gross estate under §2042(1) and Reg. §20.2042-1(b)(2). *Estate of Street v. Commissioner*, 152 F.3d 482 (5th Cir. 1998). *See also Estate of Burris v. Commissioner*, T.C. Memo 2001-210 (holding that policies owned by insured spouse with proceeds not payable to insured's estate were community property under Louisiana law, such that only one-half of proceeds was includible in insured's estate under §2042(2)).

[429] In Rev. Rul. 80-242, which dealt with a policy that was the deceased insured's separate property, the IRS ruled that under Texas law, the full amount of the proceeds was includible in the insured's gross estate, less the amount of the premiums paid with community property funds. The insured's estate also included, under §2033, the decedent's one-half community property interest in the reimbursed premiums.

[430] TAM 8951003 (Tex. law; term policy) stated:

> In this case, the predeceased spouse's estate was settled for tax purposes before the insurance policy matured. She had no right in the policy proceeds after her death. Following her death, her estate had no equity interest in that policy in the form of cash surrender rights or otherwise. Based on our review of Texas law and Service position we conclude that, in a case such as this, where the decedent changed the beneficiary after the death of the predeceased spouse and three years elapsed between the death of the predeceased spouse and the death of the decedent, during which time the policy premiums were paid with the decedent's funds, one hundred percent of the policy proceeds are includible in the decedent's estate.

[431] Rev. Rul. 75-100. In such cases, although the noninsured spouse's interest in the community property policy passes to his or her successors, including the right to receive one-half of the proceeds, the amount includible in his or her estate is limited to one-half of the interpolated terminal reserve of the policy on the date of his or her death. In this respect, the outcome is the same as it would be under the apportionment theory. *But see Estate of Cavenaugh v. Commissioner*, 51 F.3d 597 (5th Cir. 1995), rev'g in relevant part 100 T.C. 407 (1993) (rejecting IRS argument that Texas law caps noninsured spouse's community interest that has not been partitioned or settled before insured's death at one-half of cash surrender or interpolated terminal reserve value).

[432] T.C. Memo 2001-210.

[433] 429 F.2d 1058 (5th Cir. 1969).

[434] Rev. Rul. 2003-40.

[435] 61 T.C. 515, 520 (1974). Rev. Rul. 94-69 also cites *Estate of Marks v. Commissioner*, 94 T.C. 720, 724 (1990); *Bergman v. Commissioner*, 66 T.C. 887, 893 (1976).

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ignating the decedent as policy owner and the spouse as beneficiary, all the premiums for which were paid from community funds. In this situation, the decedent did not transfer ownership of the policy to the spouse, and upon the decedent's death, the proceeds were paid to the spouse. In contrast to Rev. Rul. 94-69, the IRS noted that there was no evidence that the spouse intended to transfer the spouse's community property interest in the policy to the decedent to overcome the community property presumption. Therefore, the IRS concluded that the decedent possessed one-half of the incidents of ownership "as agent for the community."[436] The IRS ruled that only one-half of the policy proceeds was properly included in the decedent's gross estate under §2042 and Reg. §20.2042-1(c)(5). If the spouse were to predecease the decedent, then, according to the IRS, one-half of the value of the policy would be includible in the spouse's gross estate under §2033 and Reg. §20.2031-8(a)(2). Citing *Cluck v. Commissioner*,[437] Rev. Rul. 2003-40 warned that taxpayers "will be held to a duty of consistency in reporting the tax treatment of life insurance policies in the estates of a husband and a wife in appropriate circumstances" and stated:

> For example, under the facts presented in this revenue ruling, D's estate may be required to include one hundred percent of the proceeds of a life insurance policy in D's gross estate if S died before D and a community property share of the value of the policy was not included in S's estate.

f. Term Life Insurance: Risk Payment Doctrine

Term life insurance, which may be issued on either an individual or a group basis, provides insurance protection for the period specified in the policy. In contrast to whole life insurance, term insurance typically does not have an investment element or a loan or surrender value. Prior to the death of the insured, the value of a term policy is generally limited to the premium cost of the insurance protection provided for the period it is in effect. The community property states generally characterize the proceeds of term insurance policies according to the source of the last premium payment — the so-called risk payment doctrine.[438] Accordingly, if the last premium on a term policy is paid with community property funds, the entire proceeds will be characterized as community property. This approach recognizes that the current protection provided by term insurance depends entirely on the last premium payment. Note, however, that courts in California have sometimes characterized term insurance according to the apportionment rule.[439]

The IRS takes, and the Tax Court has accepted, the position that the community property interest of the noninsured spouse in term insurance usually has little or no value that is includible in his or her gross estate.[440] Yet the right to renew a term policy might have a substantial value if the insured were terminally ill or uninsurable. In any case, the interest of the deceased noninsured spouse in term insurance has been held to expire with the payment of the next premium due following his or her death.[441] The Fifth Circuit, however, rejected both of these positions in *Estate of Cavenaugh v. Commissioner*[442] in excluding the noninsured spouse's community interest in a renewable term policy — determined to equal one-half of the proceeds — from the insured's estate.

8. Simultaneous Death

The simultaneous deaths of the insured and noninsured owners of a community property insurance policy sometimes produce odd substantive and tax results. Under §2042, one-half of the proceeds are includible in the insured's gross estate under §2042. The manner in which the proceeds are settled under state law determines the taxability of the other one-half of the proceeds.

Under §5 of the original Uniform Simultaneous Death Act (USDA), which may still be effect in some states, if the insured and the beneficiary died simultaneously, the insured was deemed to have survived the beneficiary.[443] In such a case, the proceeds were payable to a secondary beneficiary if one was named — in any case the proceeds were not payable to the noninsured spouse's personal representative.

According to Rev. Rul. 79-303,[444] if the proceeds of a community property policy on the life of a husband are paid to his and his wife's child as primary beneficiary upon the simulta-

[436] Rev. Rul. 2003-40.

[437] 105 T.C. 324 (1995).

[438] *Gaethje v. Gaethje*, 7 Ariz. App. 544, 441 P.2d 579 (1968); *Lock v. Lock*, 8 Ariz. App. 163, 444 P.2d 163 (1968); *Travelers Ins. Co. v. Johnson*, 97 Idaho 336, 544 P.2d 471 (1975); *Phillips v. Wellborn*, 89 N.M. 340, 552 P.2d 471 (1976); *Aetna Life Ins. Co. v. Wadsworth*, 689 P.2d 46 (Wash. 1984). In response to the *Wadsworth* decision, in 1993, the Washington legislature enacted Wash. Rev. Code §11.07.010, providing that a divorced spouse's pre-dissolution designation of the ex-spouse as beneficiary under an insurance policy is to be treated as revoked. *See Mearns v. Scharbach*, 5 P.3d 29, 33 (Wash. 2000).

[439] California appellate decisions are split regarding the proper characterization of group term insurance. *Biltoft v. Wootten*, 96 Cal. App. 3d 58, 157 Cal. Rptr. 581 (1979), holds that term insurance is subject to apportionment. In contrast, a later case holds that employment-related group term insurance is not a community asset beyond the expiration of the term acquired with community efforts, regardless of the insurability of the insured spouse. *Spengler v. Spengler*, 5 Cal. App. 4th 288, 6 Cal. Rptr.2d 764 (1992). One curious California case holds that group term insurance is not community property (*In Re Marriage of Lorenz*, 146 Cal. App. 3d 464, 194 Cal. Rptr. 237 (1983)), while another concludes that such a policy has replacement value where the insurability of the insured is lessened by age or declining health (*Marriage of Gonzalez*, 168 Cal. App. 3d 1021, 214 Cal. Rptr. 634 (1985)).

[440] *Estate of Cavenaugh v. Commissioner*, 100 T.C. 407 (1993), rev'd in relevant part, 51 F.3d 597 (5th Cir. 1995).

[441] TAM 8951003.

[442] 51 F.3d 597 (5th Cir. 1995), rev'g in relevant part 100 T.C. 407 (1993). The Fifth Circuit stated:

> If the community received all of what it bargained for in the original policy while [the noninsured spouse] lived, the post-communal renewals are separate property, but if elements of the contract remained unexpired at [the noninsured spouse's] death then the community interest survives. Examining the terms of the policy discloses several guarantees of more than de minimis import to the community's transaction…. Employing the time of acquisition rule, [the decedent's] later actions could not therefore convert the character of the property.

[443] 8A U.L.A. 561, 581 (1983). Section 5 of the original Act provided that, "Where the insured and the beneficiary in a policy of life or accident insurance have died and there is no sufficient evidence that they have otherwise than died simultaneously, the proceeds of the policy shall be distributed as if the insured had survived the beneficiary." According to its prefatory note, the revised 1993 USDA, which the states may adopt separately or as part of the Uniform Probate Code, omitted the specific provisions on insurance policies (and community property) as unnecessary. Instead, the prefatory note indicates that insurance (and community property interests) are covered by the general provisions of the 1993 Act.

[444] Note that Rev. Rul. 79-303 involves the application of the pre-1982 provisions of §2035.

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neous death of the spouses, one-half of the proceeds is includible in each spouse's estate. The basis for inclusion in the noninsured spouse's estate depends on whether that spouse was deemed to have survived the insured. If the noninsured spouse was considered to have survived, one-half was includible in his or her estate under the prior version of §2035 as a gift that became complete at the moment of death of the insured spouse and was made within three years of the noninsured spouse's death. If the noninsured spouse was not considered to have survived the insured spouse, one-half was includible in the estate under §2038. In contrast, presumably none of the proceeds would be includible in the noninsured spouse's estate under §2035 if he or she in fact had survived the insured. Instead, he or she would be treated as having made a gift of his or her one-half interest in the proceeds at the time of the insured spouse's death — which, to the extent it was a taxable gift, would be included in his or her tax base for purposes of computing the tentative tax payable by his or her estate under §2001.

Unexpected results may occur if spouses die simultaneously owning a community property policy that insures the life of one spouse and names the other as beneficiary. If no contingent beneficiary is named, the proceeds of the policy will be settled in accordance with the terms of the policy as if the beneficiary had predeceased the insured spouse. The proper result is for the estate of each spouse to be recognized as owner of a one-half interest in the policy and to be entitled to one-half of its proceeds.[445] Unfortunately, some courts applied the survivorship presumption of §5 of the original USDA through the distribution of one-half of the proceeds by the estates of each spouse.[446] Under that approach, the entire proceeds may be paid to the estate of the insured spouse to be distributed to the beneficiaries named in the insured's will or to the intestate successors of the insured. In such a case, the IRS might argue that the entire proceeds are includible in the estate of the insured — his or her one-half under §2042(2) and the noninsured spouse's half under §2042(1). The problem has been corrected by the newer version of the USDA, which applies the presumption of survivorship only to property interests passing to the other decedent at the time of simultaneous death.[447] It has also been cured legislatively in several states.[448] The survivorship presumption of §5 of the original Act was intended to deal only with the issue of survivorship of the beneficiary qua beneficiary and not to affect the beneficiary's ownership interests in the policy or the survivorship of the insured for purposes of distributing property of the beneficiary's estate.

9. *Caveat: Effect of the Revenue Act of 1942*

Care should be taken in reading cases involving community property treatment under the Revenue Act of 1942.[449] Because proceeds of community property policies were fully includible in the gross estate of the insured spouse, such cases may be confusing and are of doubtful precedential value.[450]

K. Marital Deduction Property — §2044

Under §2044, a decedent's estate must include the value of property in which the decedent held a qualifying interest for life with respect to which a gift or estate tax marital deduction had previously been allowed.[451] In the absence of such a provision, a decedent's estate is not required to include property in which the decedent was given a life estate by a third party.[452]

The qualified terminable interest property may have been either the donor spouse's separate property or the donor's interest in the community property of the spouses. In either case, the donee spouse's interest in qualified terminable interest property (QTIP) is properly treated as separate property — it is simply property that the donee received by gift, devise, or bequest. Whether the donee received the interest by inter vivos gift, devise, or bequest, the amount includible under §2044 is limited to the portion of the property transferred by the transferor spouse for which a marital deduction was claimed. Any interest in property that was transferred by the donee spouse to a QTIP trust under a survivor's election is includible in gross estate under §2036 (retained life estate). Of course, if the transfers involved a forced surviving spouse's election, the donee spouse's estate may be reduced by an offset allowable under §2043.[453]

For further discussion of marital deduction property, see 843 T.M., *Estate Tax Marital Deduction.*

L. Expenses, Indebtedness, and Taxes — §2053

Section 2053 provides for the deduction of allowable expenses, administration expenses, claims against the estate, and mortgages or other indebtedness. The amounts deductible in community property jurisdictions vary because of differences in local law and the limitation imposed by §2053(a) that such amounts be "allowable by the laws of the jurisdiction … under which the estate is being administered."

For further discussion of estate tax deductions, see 840 T.M., *Estate Tax Deductions — Sections 2053, 2054 and 2058.*

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[445] This result is called for under the optional language of §5 of the original USDA that was recommended for adoption in community property states. Under that section, "if the policy is community property of the insured and his spouse, and there is no alternative beneficiary except the estate or personal representative of the insured, the proceeds shall be distributed as community property under Section 4." Section 4, in turn, provided that one-half of the property should be disposed of as if the husband had survived and one-half as if the wife had survived. As noted above, the revised 1993 USDA does not include specific provisions on insurance or community property. The revised Act treats the deaths as simultaneous if within 120 hours of each other.

[446] *Estate of Wedemeyer v. Sullivan*, 109 Cal. App. 2d 67, 240 P.2d 8 (1952); *Watkins v. Sellers*, 64 Wash.2d 320, 391 P.2d 547 (1964); *Austin v. Majors*, 51 Wash.2d 274, 317 P.2d 528 (1957).

[447] USDA §2 (Unif. Law Comm'n 1993).

[448] Cal. Prob. Code §221(b); Idaho Code §15-2-613(c); Nev. Rev. Stat. tit. 12, §135.050; Tenn. Code Ann. §121.153; Tex. Est. Code Ann. §121.153; Wash. Rev. Code §11.05A.030; Wis. Stat. §854.03.

[449] Pub. L. No. 77-753.

[450] *See, e.g., Fernandez v. Weiner*, 326 U.S. 340 (1945) (La. law); *Godfrey v. Smyth*, 87 F. Supp. 982 (N.D. Cal. 1949), aff'd per curiam, 180 F.2d 220 (9th Cir. 1950) (Cal. law); *Estate of Larsh v. Commissioner*, 8 T.C.M. 799 (1949) (Cal. law).

[451] Section 2523(f) permits a donor spouse to claim a marital deduction for property in which the donee spouse is given a qualifying income interest for life. A decedent spouse's executor may make a similar election for property in which the decedent's surviving spouse is given such an interest. §2056(b)(7). *See* 843 T.M., *Estate Tax Marital Deduction.* A sample election statement, *Estate: Qualified Terminable Interest Property (QTIP) Election (§2056(b)(7) and §2523(f))*, is included in the Bloomberg Tax Elections & Compliance Statements.

[452] *See, e.g., Helvering v. Safe Deposit & Tr. Co.*, 316 U.S. 56 (1942).

[453] See the discussion of the forced survivor's election at VII.A., below.

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1. *Funeral Expenses*

Funeral expenses are deductible as allowed by the jurisdiction in which the estate is administered. In the leading case on the subject, *Estate of Lang v. Commissioner*,[454] the Ninth Circuit held that only one-half of the funeral expenses paid for a Washington decedent were deductible because such expenses were "a primary community obligation" under Washington law. Apparently, the same result applies to Arizona estates.[455] A different result is reached in states that impose the primary obligation to pay funeral expenses on a decedent's estate. Thus, in *Estate of Lee v. Commissioner*,[456] the Tax Court held that the *Lang* case did not require halving funeral expenses in an Idaho estate. After noting that such expenses constituted a community obligation in Washington but did not constitute such an obligation under the laws of Idaho, the court held the funeral expenses were deductible in full from the decedent's property. The full amount of funeral expenses also appears to be deductible in Louisiana.[457]

The rule in Texas is the same, although by ruling, case, and statute, it has gone full circle. In 1931, the Fifth Circuit decided in *Blair v. Stewart*[458] that the decedent's funeral expenses were payable from his share of the community property, and hence fully deductible for estate tax purposes. *Stewart* was followed until 1966, when the IRS ruled that the law of Texas was not as earlier supposed and that the IRS would no longer allow the full amount of funeral expenses to be deducted from a married decedent's estate.[459] In 1968, the Fifth Circuit overruled *Stewart*.[460] In the meantime, the Texas legislature amended the statute, effective May 27, 1967, to provide that funeral expenses were to be charged entirely to the decedent's share of the community property.[461] The amendment produced the desired result; in 1969 the IRS ruled that the full amount of funeral expenses were deductible.[462]

The cases and rulings initially limited the deductibility of funeral expenses in California to an amount:[463]

> [C]alculated by multiplying the amount of funeral expenses by the fraction of which the numerator is the value of the separate property of the decedent plus one-half of the value of the community property, and of which the denominator is the value of the separate property of the decedent plus the entire value of the community property.

California responded by amending its law to impose the obligation to pay the full amount of funeral expenses on a decedent's property. In due course, the IRS ruled that the full amount of funeral expenses was deductible with respect to decedents dying on or after June 17, 1970.[464]

In New Mexico, funeral expenses of a married person are chargeable primarily against the decedent's separate property and secondarily against his or her share of the community property.[465] Accordingly, the full amount of the expenses should be deductible in New Mexico under §2053. Funeral expenses of a married decedent are fully deductible in Wisconsin.[466]

2. *Administration Expenses*

The costs of administering community property are deductible only to the extent that they are chargeable against the decedent's share of the property under local law. A testamentary direction that all administration expenses be paid from the decedent's share of the community property cannot increase the deductible amount — such a direction is simply an additional gift to the surviving spouse.[467] If all of the community property (and not merely the decedent's share thereof) is subject to administration upon the death of the first spouse to die, only one-half of routine expenses of administering the community property is deductible.[468] This approach is based upon an assumption that the administration of the surviving spouse's share of the community property was of benefit to the survivor as a result of which one-half of the costs of administration is properly chargeable against the survivor's share. Note, however, that the decedent's estate can fully deduct the expenses of administration attributable to separate property and the expenses that are specifically referable to administration of the decedent's share of the community property. The rule is summarized in the following passage of Rev. Rul. 66-21:

> Accordingly, it is held that only one-half of the administration expenses are allowable as a deduction under § 2053(a) of the Code in the estate of a decedent subject to Texas community property law, except where separate property is also administered in the estate, in which case the deduction is allowable proportionately. However, expenses which can be specifically allocated to the decedent's share of the community property, such as attorney's fees incurred in the determination or litigation of estate and inheritance taxes in connection with his share of the property, are fully deductible. Expenses incurred solely in

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[454] 97 F.2d 867 (9th Cir. 1938) (Wash. law).

[455] Rev. Rul. 78-242 (Ariz. law).

[456] 11 T.C. 141 (1948), acq., 1948-2 C.B. 3 (Idaho law).

[457] *McCullough v. United States*, 134 F. Supp. 673 (W.D. La. 1955).

[458] 49 F.2d 257 (5th Cir. 1931) (Tex. law).

[459] Rev. Rul. 66-21 (Tex. law), *modified by* Rev. Rul. 69-193.

[460] *United States v. Collins*, 399 F.2d 90 (5th Cir. 1968) (Tex. law).

[461] Tex. Est. Code Ann. §355.110. The Texas Probate Code was recodified without modification under the Texas Estate Code, effective January 1, 2014. 2009 Tex. Acts, 81st Leg., R.S., Ch. 680 (H.B. 2502, §11).

[462] Rev. Rul. 69-193 (Tex. law), *modifying* Rev. Rul. 66-21. *See* Tex. Est. Code Ann. §355.110(2).

[463] *Estate of Rowan v. Commissioner*, 54 T.C. 633 (1970) (Cal. law).

[464] Rev. Rul. 71-168 (Cal. law), *modifying* Rev. Rul. 70-156. *See* Cal. Prob. Code §11446.

[465] N.M. Stat. Ann. §45-2-807(B).

[466] Wis. Stat. §859.49. *See also* Joseph Witmer, *Reimbursement of Husband for Funeral Expenses Out of Separate Estate of Deceased Wife*, 10 Marq. L. Rev. 72 (1926).

[467] *United States v. Stapf*, 375 U.S. 118 (1963). In *Stapf*, the court held that "the payments made as a result of the testator's assumption of responsibility both for his wife's share of the community debts and for her share of the administration expenses are more properly characterized as marital gifts rather than as 'claims' or 'expenses.'" 375 U.S. 118, 134.

[468] *Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938); *Ferguson v. United States*, 81-1 USTC ¶13,409 (D. Ariz. 1981) (Ariz. law); *Schuhmacher v. Commissioner*, 8 T.C. 453 (1947) (Tex. law); *Estate of Lee v. Commissioner*, 11 T.C. 141 (1948) (Idaho law); *Estate of Hutson v. Commissioner*, 49 T.C. 495 (1968) (Cal. law); *Estate of Davis v. Commissioner*, 51 T.C. 361 (1968). Under Washington law, all community property is subject to administration in the estate of a deceased spouse. Wash. Rev. Code §11.02.070.

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> determining estate tax liability are allowable in full to the decedent's estate.

In *Ray v. United States*,[469] the court allowed the estate to deduct (1) attorney's fees in connection with determining the state and federal death and income taxes and those incurred in performing ordinary probate services for the decedent's estate, which together amounted to 95% of the attorney's fees, and (2) administration expenses that would not otherwise have been incurred, including appraisal fees and costs of selling the decedent's interest in property.

Cases involving Louisiana law also recognize the full deductibility of expenses of administration that are specifically referable to the decedent's estate:[470]

> The law of Louisiana regarding the question of who bears the cost of administering a community estate depends upon the factual determination of whether administration is necessary for the settlement of the affairs of the entire community or whether administration is necessary only for the purpose of facilitating the computation and payment of the State and Federal inheritance and estate taxes due by the estate. If administration is necessary for the settlement of the affairs of the entire community, the administration expenses are to be borne by the decedent's share of the community and the wife's share equally. If, on the other hand, administration is necessary only for the purpose of facilitating the computation and payment of the State and Federal taxes due by the estate, the administration expenses are to be borne entirely by the decedent's share of the community.

In certain situations, estates are allowed to defer the payment of estate taxes.[471] When an estate defers the payment of taxes under §6166, the estate pays a reduced interest rate on that deferral. However, the estate is not entitled to deduct the interest paid pursuant to §6166.[472] As indicated in PLR 9123024, if all of a decedent's separate and community property is subject to claims against the estate, the deduction will be fully allowable and is not limited to interest paid before the expiration of the period of limitations for assessments.

3. Claims, Mortgages, and Other Encumbrances

One-half of the amount of community property debts is properly deductible by a decedent spouse's estate.[473] The rule applies even if the decedent directed that all of the expenses of his or her last illness should be charged against his or her estate.[474] As noted previously, where the decedent is personally liable for community debts and dies owning separate property, and the community property is insufficient to discharge all such debts, presumably a community claim is deductible to the extent of the value of separate property that is required, in addition to the community property, to satisfy it.[475] By the same token, claims or encumbrances relating to separate property of the decedent are fully deductible.[476] Unpaid taxes burdening community property or constituting community debts are deductible to the extent of 50%.[477]

The manner in which an unpaid mortgage is taken into account on the federal estate tax return depends upon whether the estate is liable for the unpaid amount. Under Reg. §20.2053-7, if the estate is subject to personal liability on the mortgage, the full value of the property is included in the gross estate and the amount of the mortgage is deducted. On the other hand, if the estate is not liable, only the net value of the property (the value of the property less the mortgage) is included in the decedent's gross estate and no deduction is allowed. The amount of mortgage indebtedness on community property is deductible to the extent of 50%.[478] The full amount of mortgages against the decedent's separate property is deductible.[479]

As noted above,[480] under Texas and Louisiana law, the community has a right to reimbursement for premiums paid with community property funds on a separate property policy. This right is generally characterized as an equitable lien, enforceable against the proceeds of the policy. If the amount of the proceeds exceeds the amount of the premiums paid with community funds, the right is not enforceable against the decedent's estate. Under that approach, no deduction is allowable under §2053. A Tax Court decision applying Texas law held that the proper resolution in such a case is to include in the insured's estate two separate items: (1) the amount of the policy proceeds less the amount of the premiums paid from commu-

[469] 385 F. Supp. 372 (S.D. Tex. 1974), aff'd on other issues, 538 F.2d 1228 (5th Cir. 1976).

[470] *Estate of Helis v. Commissioner*, 26 T.C. 143, 148 (1956) (La. law). *See Estate of Gannett v. Commissioner*, 24 T.C. 654 (1955) (La. law); *Vaccaro v. United States*, 55 F. Supp. 932 (E.D. La. 1944), aff'd, 149 F.2d 1014 (5th Cir. 1945) (La. law).

[471] §6161, §6163, or §6166.

[472] §2053(c)(1)(D). *See also* Prop. Reg. §20.2053-3(d)(a)(i), REG-130975-08, 87 Fed. Reg. 38,331 (June 28, 2022). The proposed regulations note the distinction between "Section 6166 interest" which is nondeductible and "Non-section 6166 interest" (generally interest payable under §6161 and §6163) which is generally deductible with certain exceptions. Note also that the proposed regulations would limit the amount of "non-§6166 interest" that is deductible by incorporating present-value principles in determining the amount deductible under §2053 for claims and expenses under §6161 and §6163. Prop. Reg. §20.2053-1(d)(6).

[473] Rev. Rul. 78-242 (Ariz. law).

[474] Rev. Rul. 78-242.

[475] *United States v. Stapf*, 375 U.S. 118 (1963) (Tex. law); *Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938) (Wash. law); *Estate of Davis v. Commissioner*, 51 T.C. 361 (1968) (Cal. law); *Estate of Hutson v. Commissioner*, 49 T.C. 495 (1968) (Cal. law).

[476] *See Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938) (Wash. law).

[477] *United States v. Stapf*, 375 U.S. 118, 132 (1963) (Tex. law). According to *Stapf* under Texas law:

> The community is liable for its debts, and, accordingly, half the debts attach to the wife's community property. Since the will of the decedent cannot be allowed to define what is an "obligation" or a "claim" where, as in this case, the community is solvent, the debts chargeable to the wife's property cannot realistically be deemed "personal obligations" of the decedent or "claims against" his estate.

[478] In applying the formula for allocating allowable deductions between community and noncommunity property for the purpose of determining the marital deduction allowable under the provisions of former §2056(c)(2)(B), several courts held that the full value of the decedent's interest in a community property residence is included in the gross estate and a deduction is allowed for the decedent's one-half share of the unpaid mortgage. *Estate of Linderoth v. Commissioner*, T.C. Memo 1986-547 (Nev. law); *Colwell v. United States*, 676 F.2d 550 (Ct. Cl. 1982) (Tex. law); *see also Estate of Eldred v. Commissioner*, T.C. Memo 1989-293; GCM 36709 (Apr. 19, 1976).

[479] Note that proposed regulations using present value calculations to determine valuing debts does not apply to mortgages. *See* Preamble, REG-130975-08, 87 Fed. Reg. 38,331 (June 28, 2022).

[480] *See* IV.J.7.c., above.

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nity funds, and (2) one-half of the amount of such premiums.[481] Later, in Rev. Rul. 80-242,[482] the IRS ruled that the proper treatment was to include the amount of the proceeds less one-half of the amount of the premiums paid with community funds.

A claim may be asserted against the estate of the surviving spouse who administered the estate of the first-to-die spouse and retained the decedent's share of the community property rather than distributing it to the person who was entitled to receive it from the decedent's estate.

M. Losses — §2054

The deduction available under §2054 for losses from casualties or theft contains no special provision regarding community property. Presumably one-half of the amount of an unreimbursed loss of an item of community property is deductible by the estate of a deceased spouse. A decedent's estate should be entitled to deduct the full amount of a loss incurred with respect to the interest in an item of community property that the estate retained after the property was partitioned and the other one-half was distributed to the surviving spouse. In the administration of the decedent's estate, an item of property that was formerly held as the community property of the couple may be divided between the decedent's personal representative and the surviving spouse so that each has either the entire interest in one-half of the whole (e.g., the personal representative and the surviving spouse divide 100 shares of XYZ, Inc. stock between them so each owns 50 shares) or an undivided interest in the whole.[483]

N. Transfers for Public, Charitable, and Religious Uses — §2055

The almost complete absence of authority regarding the tax treatment of transfers of community property to or for the benefit of charities is surprising. Issues regarding deductibility or valuation might arise in connection with a post-mortem transfer to charity of the deceased spouse's interest in community property. One Tax Court case, *Estate of Sumner v. Commissioner*,[484] concluded that the amount of the testamentary gift to charities of the remainder interest in a trust would not be reduced by the value of an interest in the trust that passed to the decedent's wife. That interest had a lower value than the surviving spouse's share of the community property that she elected to allow to pass to the charitable remainder beneficiaries. The decision relied on the approach taken in *United States v. Stapf*,[485] the leading surviving spouse's election case, in which the amount of the marital deduction allowed to the decedent's estate was reduced by the value of the surviving spouse's interest in the community property that she was required to give up. The approach taken in *Sumner* remains valid, although it arose prior to the enactment of the Tax Reform Act of 1969.[486] The Tax Reform Act of 1969 imposed strict limitations on the form of split interest trusts — ones with both private and charitable beneficiaries.

In valuing a decedent's gifts of community property to charity, the government can argue that the gifts are subject to the discounts that the courts upheld in *Propstra v. United States*,[487] *Estate of Bright v. United States*,[488] and *Estate of Lee v. Commissioner*.[489] Under those cases, the decedent's interest in community property shares of closely held stock or real property is subject to a discount because of its minority or partial nature. Essentially, the same issues regarding valuation and deductibility might also arise in the context of inter vivos gifts to charity, — which can be made in some jurisdictions by one spouse without the consent of the other.[490]

O. The Marital Deduction — §2056

1. Current Law

Section 2056 allows an unlimited marital deduction to the estates of decedents for property passing to a surviving spouse in a qualifying way, regardless of the character of the property.[491] The community property included in a decedent's gross estate qualifies for the marital deduction to the same extent as separate or common law property, whether or not the property was ever separate or common law property. Community and separate property are both subject to the terminable interest rule and the citizenship requirement for the surviving spouse.

Section 2056(b)(7)(C) provides that the QTIP marital deduction is available for a nonparticipant spouse's interest in a qualified plan annuity attributable to community property laws where he or she predeceases the participant spouse.[492] Thus, the nonparticipant spouse's interest in an annuity arising under state community property laws that passes to the surviving participant spouse may qualify as QTIP property under §2056(b)(7).

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[481] *Estate of Wildenthal v. Commissioner*, T.C. Memo 1970-119 (Tex. law).

[482] Covering Texas law, *modifying* Rev. Rul. 54-272.

[483] The surviving spouse and the deceased spouse's successors may agree upon a non-pro rata distribution of the former community property. Such a distribution should not involve a taxable exchange. PLR 9537011, PLR 8037124, PLR 8016050. The same result was reached where the distribution was made pursuant to an agreement between the surviving spouse and the decedent's personal representative, who was authorized by the decedent's will to enter into it. TAM 8505006 (Cal. law). The personal representative may be authorized by local law to make a non-pro rata distribution of community property without the surviving spouse's consent. *See, e.g.*, Wash. Rev. Code §11.68.090 (1998).

[484] 59 T.C. 837 (1973).

[485] 375 U.S. 118 (1963).

[486] Pub. L. No. 91-172.

[487] 680 F.2d 1248 (9th Cir. 1982).

[488] 658 F.2d 999 (5th Cir. 1981).

[489] 69 T.C. 860 (1978), nonacq., 1980-1 C.B. 2, acq., Rev. Rul. 93-12. *Propstra*, *Bright*, and *Lee* are discussed at IV.J.3., above.

[490] Under Washington law, an inter vivos gift of community property made by one spouse without the other's consent can be invalidated by the nonconsenting spouse. Wash. Rev. Code §26.16.030(2).

[491] The current rule is the result of the amendment of §2056 by ERTA, Pub. L. No. 97-34, §403(a).

[492] Section 2056(b)(7)(C) applies to estates of decedents dying after August 5, 1997. The Retirement Equity Act of 1984, which created automatic spousal survival benefits in qualified plans, also created uncertainty about the marital deduction treatment of qualified plans for spouses who live in community property states. The 1997 Act, Pub. L. No. 105-34, §1311, clarified this treatment for purposes of the QTIP marital deduction. The Conference Report to the 1997 Act states that this provision is not intended to modify the result of the Supreme Court's decision in *Boggs v. Boggs*.

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2. Prior Law

a. Generally

The amendments made by the Revenue Act of 1948[493] were intended to equalize the effect of estate taxes in community property and common law jurisdictions.[494] As stated in *Stapf*:[495]

> Under a community property system, such as that in Texas, the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively-scaled estate taxes and to adhere to the patterns of state law, the marital deduction permits a deceased spouse, subject to certain requirements, to transfer free of taxes one-half of the [the value of] non-community property to the surviving spouse. Although applicable to separately held property in a community property state, the primary thrust of this is to extend to taxpayers in common-law States the advantages of "estate splitting" otherwise available only in community property States. The purpose, however, is only to permit a married couple's property to be taxed in two stages and not to allow a tax-exempt transfer of wealth into succeeding generations. Thus the marital deduction is generally restricted to the transfer of property interests that will be included in the surviving spouse's gross estate.

Between 1948 and 1977, the marital deduction was limited by former §2056(c) to 50% of the decedent's adjusted gross estate — essentially the value of the gross estate less the value of the decedent's interest in the community property and less the portion of §2053 and §2054 deductions attributable to the separate property. In broad terms, the marital deduction was limited to half the value of the decedent's separate property. During that period, no marital deduction was allowable to an estate that was entirely composed of the decedent's interest in community property. Note, however, that, subject to the 50% limit established by former §2056(c), a marital deduction was allowable for the value of community property transferred to the surviving spouse in an otherwise qualifying way. That is, if a decedent's estate included separate property, a deduction was allowable even though the surviving spouse received only community property.

The Tax Reform Act of 1976[496] amended former §2056(c) to allow a marital deduction of the greater of $250,000 or 50% of the decedent's adjusted gross estate — less, however, the value of community property included in the decedent's gross estate. Because of the required reduction for the decedent's interest in community property, the change was of little benefit to residents of community property states.

b. The Special Definition of Community Property

The definition of community property was critical to the computation of the maximum marital deduction under former §2056(c). The ordinary community property classification under former §2056(c) included:

> (i) the value of property which is at the time of the death of the decedent held as such community property;
>
> (ii) the value of property transferred by the decedent during his life, if at the time of such transfer the property was held as such community property; and
>
> (iii) the amount receivable as insurance under policies on the life of the decedent, to the extent purchased with premiums or other consideration and out of property held as such community property….

The rules also prevented spouses from creating separate property by converting community property into equal shares of separate property. Under former §2056(c)(1)(C), property converted from community property into separate property after December 31, 1941, or the proceeds thereof, was treated as community property to the extent that it resulted from an equal division of such community property. Accordingly, the separate property of a husband that was allocated to him as his share of the community property when he and his wife divorced in 1958 was treated as community property following their remarriage.[497]

The adjustments for community property only applied to property that was includible in the decedent's gross estate.[498] The point was of peculiar importance in those community property states in which life insurance policies acquired out of separate property remained separate property although substantial premium payments were made out of community funds.[499]

In addition, any community property that was fully includible in the gross estate of the husband (as in the case of pre-1927 California community property) was not regarded as community property for former §2056(c)(2) purposes.[500] Similarly, any separate property that resulted from a division of community property made prior to January 1, 1942, or (if it occurred thereafter) to the extent that the value of the separate property acquired by the decedent exceeded the value of the separate property acquired by his or her spouse, was treated as separate property.[501]

3. Reduction of Marital Deduction in Surviving Spouse's Election Cases — §2056(b)(4)

A marital deduction is only allowable for the net value of the property interests that pass to the surviving spouse. Under the general rule of §2056(b)(4), the amount of an otherwise allowable marital deduction is reduced by the amount of death taxes charged against the property, any encumbrances on it, and the amount of obligations imposed by the decedent on the surviving spouse. The allocation of the burden on paying death

[493] Pub. L. No. 80-471.
[494] *United States v. Stapf*, 375 U.S. 118, 128 (1963).
[495] *United States v. Stapf*, 375 U.S. 118, 128 (1963).
[496] Pub. L. No. 94-455, §2002(a).
[497] Rev. Rul. 73-309.
[498] Former Reg. §20.2056(c)-2(a)(1)–§20.2056(c)-2(a)(4).
[499] See the discussion of this point at IV.J.7., above.
[500] Former §2056(c)(2)(B); former Reg. §20.2056(c)-2(d).
[501] Former §2056(c)(2)(C); former Reg. §20.2056(c)-2(e)–§20.2056(c)-2(g).

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taxes is largely determined by state law under which a marital deduction gift may be relieved from any requirement that it contribute toward the payment of the taxes.[502] The reduction that must be made with respect to obligations imposed on the surviving spouse extends to the surviving spouse's election in community property states under which the deceased spouse's will typically requires the surviving spouse to elect whether to receive the benefits provided under the trust established by the decedent's will and transfer her share of the community property to the same (or a similar) trust, or to retain her share of the community property and forego the benefits provided under the decedent's will.[503]

The regulations include an example illustrating the application of the rule to a will that required the surviving spouse to make an election for the disposition of the community property:[504]

> A decedent bequeathed certain securities to his wife in lieu of her interest in property held by them as community property under the law of the State of their residence. The wife elected to relinquish her community property interest and to take the bequest. For the purpose of the marital deduction, the value of the bequest is to be reduced by the value of the community property interest relinquished by the wife.

4. *Credit for Tax on Prior Transfers — §2013*

Credits are allowed against the estate tax on community property and on common law property. There appears to be only one issue regarding credits that is unique to community property. It occurs in computing the credit for tax on prior transfers.

Section 2013 allows a credit of "all or part of the amount of Federal estate tax paid with respect to the transfer of property … to the decedent by or from a person … who died within 10 years before, or within 2 years after, the decedent's death." The amount of the credit is computed, in general, by multiplying the estate tax paid for the transferor by a fraction, the numerator of which is the value of the property transferred, and the denominator of which is the taxable estate of transferor.[505] The credit is limited to the amount of the decedent's estate tax attributable to the property transferred.[506] Thus, the value of the property transferred is a pivotal value.

In computing this credit, the value of the property is its value for purposes of determining the transferor's estate tax liability, subject to three adjustments. The second of these adjustments is as follows:[507]

> [W]here such property is encumbered in any manner, or where the decedent incurs any obligation imposed by the transferor with respect to such property, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to the decedent of such property was being determined….

The regulations contain directions for the application of this limitation to a type of community property surviving spouse's election:[508]

> For purposes of this subparagraph, an obligation imposed by the transferor and incurred by the decedent with respect to the property includes a bequest, etc., in lieu of the interest of the surviving spouse under the community property laws, unless the interest was, immediately prior to the transferor's death, a mere expectancy.

The application of the rule is illustrated by Reg. §20.2013-4(b)(4)(iii) *Ex.* (3):

> The transferor bequeathed certain property to his wife, the decedent, in lieu of her interest in property held by them as community property under the law of the State of their residence. The wife elected to relinquish her community property interest and to take the bequest. The value of the property transferred to the decedent is the value of the property reduced by the value of the community property interest relinquished by the wife.

The regulation properly applies in the case of outright bequests, but not to the usual forced surviving spouse's election in which the surviving spouse is considered to have exchanged a remainder in her share of the community property for a life estate in the decedent's share. As the Tax Court stated with respect to the latter case:[509]

> It follows logically that if the obligation which the transferor incurred did not reduce the amount included in her estate for estate tax purposes, such an obligation should not reduce the value of the property transferred to the estate that is subject to the credit under §2013. This is precisely why we must allow the petitioner the claimed credit under §2013 and prevent the inequity of a double taxation on the same item.

The court distinguished the example in the regulations because, in terms of tax effect, the transfer with a retained life estate is quite different from a relinquishment of an absolute interest in property. An amendment to the regulation, making clear that it applies only in situations in which the excess of the value of the surviving spouse's transfer over the value of the consideration offset was not includible in the surviving spouse's gross estate, might make the distinction a somewhat more comfortable one.[510]

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[502] In *Estate of Phillips v. Commissioner*, 90 T.C. 797 (1988), the amount of the marital deduction gift was reduced for the portion of the estate tax on the specific gifts that was properly charged against the residuary marital deduction gift as required by the decedent's will. However, under Louisiana law, a direction to pay death taxes from the residue did not constitute a direction against apportioning among the residuary beneficiaries the taxes imposed on the residue. Accordingly, the residuary marital deduction gift was not required to pay any portion of the death taxes that were attributable to other, nondeductible residuary gifts.

[503] *See* IV.F.1.d., above, V.D.3., below. Under pre-1982 law, this rule had limited applicability: before 1982, a marital deduction was only allowed if the decedent's estate included some common law or true separate property. Absent such property, the adjusted gross estate figure was zero, and no deduction was allowed. The Supreme Court in *United States v. Stapf*, 375 U.S. 118 (1963), upheld the adjustment provided for in the regulation.

[504] Reg. §20.2056(b)-4(b) *Ex.* (3).

[505] §2013(b).

[506] §2013(c).

[507] §2013(d)(2).

[508] Reg. §20.2013-4(b)(4)(ii).

[509] *Estate of Sparling v. Commissioner*, 60 T.C. 330, 346 (1973).

[510] *See* 844 T.M., *Estate Tax Credits and Computations.*

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P. Portability

The availability of the "portability election" under §2010(c)(4) has different effects depending on the differences in the community property regimes among the various community property jurisdictions. In a state like California, which currently has no estate tax, planning for portability is quite different from planning for portability in a state like Washington, which does impose an estate tax. As most states have not enacted portability legislation of their own under their state estate tax provisions, the availability of portability of the federal exemption amount has served to widen the gap between federal and state estate tax systems.

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V. Gift Tax Considerations

A. Transfers of Property by Gift

1. Transfers to Third Parties

A gift of community property to a third party is a gift by each spouse of his or her interest in the community property. This approach is reflected on page 2 of the Instructions for Form 709: "If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return." Each spouse is treated as a donor because each owned a one-half interest in the donated property.[511] If a gift of community property is made by one spouse alone, a type of transfer which is permitted to a limited extent in some community property states, then both spouses will still be treated as donors for gift tax purposes.

2. Transfer by One Spouse to the Other

A transfer of one spouse's interest in an item of community property to the other spouse involves a single gift — from the donor spouse to the donee spouse. Note that the record title of an asset does not control its separate or community character. Thus, under most circumstances, an asset acquired with community property funds retains its community character although title is taken in the name of one spouse alone. Similarly, the transfer of the title of a community property asset into the name of both spouses may not affect the spouses' ownership interests in it.[512] That is, transfer of record title into the name of one spouse or into the names of both spouses may simply reflect a change of the particular way in which title is held without affecting ownership interests in the asset. The outcome in any given case will be influenced by the relatively strong presumption that all property acquired during marriage is community property. Specific state law will also affect the determination of ownership regardless of title.[513] The federal gift tax law is concerned only with interspousal transfers in which there is a change in the ownership interests in the property.

A change in the ownership interests by the spouses in their community or separate property is treated as a gift from one spouse to the other. Thus, the following transactions are all deemed gifts: (1) a transfer of separate or common law property by either spouse, to both spouses as community property; (2) a transfer of community property to one of the spouses as his or her separate property; and (3) a transfer of the separate property of one spouse to the other spouse as his or her separate property. A gift also results where the spouses convert unequal amounts of separate property into community property.[514] A transfer of a community property asset into the name of one of the spouses as community property does not usually constitute a gift. Such a transfer of title would not constitute a gift if there is no change in the spouses' underlying ownership interests in the asset. A gift from one spouse to the other occurs if community property is transmuted into unequal separate property holdings:[515]

> In the instant case, the value of the property interest B [wife] is transferring pursuant to the "Transmutation Agreement" (her ½ interest in A's [husband's] IRA) exceeds the value of the property interest she is receiving in exchange (a ½ interest in the "Other Assets"). Thus, as a result of the "Transmutation Agreement," B will make a gift to A. However, the property transferred by B to A under the "Transmutation Agreement" will qualify for a marital deduction under §2523(a) of the Code.

A transfer of community property to an irrevocable trust in which the spouses retain the right to receive the income for their lives, with the remainders to one or more third party beneficiaries, is only a gift by them to the third-party remainder beneficiaries. If the income of the trust is payable to one spouse as his or her separate property, the other spouse would also have made a gift to the income beneficiary spouse.

B. Forms of Transfer

1. Commingling

The separate property of a spouse that is mixed with community property may lose its identity and become community property.[516] The gradual and, perhaps, inadvertent transmutation by commingling has not been treated as a gift for federal gift tax purposes. There is, however, some possibility that the IRS might challenge a contention that the separate property of one spouse had become the couple's community property. The issue might arise, for example, if the "donee" spouse were a non-citizen, gifts to whom would not qualify for the unlimited gift tax marital deduction. In the single reported case in which commingling was raised by the taxpayer, who argued that the gift to his spouse by a transmutation agreement was small as most of his separate property had already been converted by commingling, the Court noted that the state law presumption of community property does not overcome the presumption in favor of the IRS's determination and, thus, the taxpayer retains the burden of proof.[517]

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[511] Consistent with the estate tax law of the times, gifts of community property made between January 1, 1943 and April 2, 1948 were treated as entirely made by the husband, just as if the gifted property had been the common law or husband's separate property. An exception to the treatment was made insofar as the community property was "shown to have been derived as compensation for personal services actually rendered by the wife" or from the wife's separate property. *See* 1939 Code §1000(d); former Reg. §1.108, §86.2(c). This short-lived provision is mentioned because of the confusion that might be caused by the few cases decided under it.

[512] *See Estate of Borghi*, 167 Wash.2d 480 (2009).

[513] Id.

[514] Rev. Rul. 77-359 (agreement converting separate property of each spouse into community property results in a single gift of the "net difference between the value of the husband's (or the wife's) separate property before its conversion into community property and the value of the husband's (or the wife's) interest in the community property resulting from the conversion").

[515] PLR 8929046.

[516] The extent of proof required to maintain the separate character of separate property that has been commingled with community property varies from state to state.

[517] *Damner v. Commissioner*, 3 T.C. 638 (1944), *acq.*, 1944 C.B. 6 (Cal. law).

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2. *Joint Ownership Forms*

a. *Survivorship Community Property*

Statutes in all community property states except Louisiana and Texas allow titling of community property in a way that creates a joint tenancy with right of survivorship. Although joint tenancies with right of survivorship and community property are traditionally considered to be mutually exclusive, if a married couple converts community property into a joint tenancy with right of survivorship, the property was no longer considered community property and, thus, the couple will have lost the benefit of the double step up in basis allowed by §1014(b)(6). States have addressed this issue in different ways. Some states, such as New Mexico and Washington, have enacted statutes providing that property held by a married couple as joint tenants with right of survivorship is presumed to be community property, thus retaining the double step up.[518] Other states have statutorily created a separate category of holding title to property, community property with right of survivorship.[519] In Rev. Rul. 87-98, the IRS recognized the effect of such statutes and allowed a full step-up in basis for community property with right of survivorship. In a state that does not have such a statute, each spouse may be treated as owning an undivided one-half interest in joint tenancy property as separate property.[520] If the property was the separate property of each of the spouses, then, upon the death of one spouse, the surviving spouse's basis in the property would be a composite, one-half of which would equal the pre-death adjusted basis in the property, and one-half would equal the property's value for federal estate tax purposes.

No gift should result from the transfer of a community property asset into a severable joint tenancy between the spouses, regardless of whether or not their interests in the property remain community in nature or become their separate property. In either case, the spouses will each own an equal one-half interest in the asset.

The conversion by both spouses of community property into a joint tenancy with rights of survivorship may technically constitute a gift from one spouse to the other. The value of the gift would be the difference between the actuarially determined values of the spouses' respective interests in the property subject to the survivorship arrangement.[521] However, if no third party has an interest in the property, presumably any gift made by one spouse to the other would qualify for the unlimited marital deduction.[522] Accordingly, it is unlikely that the IRS will raise the issue where the spouses are the only interested parties and neither is a non-citizen.[523] The IRS has held that, under Texas law, a surviving spouse can validly disclaim her right to receive the deceased spouse's one-half interest in assets in a brokerage account that were "held as community property with right of survivorship."[524]

b. *Agreements Governing Disposition of Community Property upon Death of a Spouse*

The laws of Idaho, Texas, Wisconsin, and Washington allow spouses to enter into written agreements regarding the disposition of their property at death.[525] For example, a Wisconsin statute allows a marital property agreement to provide that the property of either or both spouses will pass, upon the death of either spouse, "without probate to a designated person, trust or other entity by nontestamentary disposition."[526] An agreement governed by Idaho and Wisconsin laws may apply to both separate and community property; however, the Washington statute allows agreements to be made only with respect to community property.[527]

c. *Transfer of Community Property into Tenancy in Common*

The conversion of community property into separate property owned as a tenancy-in-common by the spouses does not involve a taxable transfer for federal estate or gift tax purposes. In *Rickenberg v. Commissioner*,[528] a case involving the estate tax, the Court held that an agreement between a husband and wife changing the form of ownership of their property from community property to tenancy-in-common was not a transfer of an interest in property.[529]

d. *Agreements Regarding Character of Future Earnings*

An agreement between spouses that converts the future earnings of one or both spouses into the separate property of the recipient spouse is valid in at least some community property states.[530] If such an agreement is effective, it may result in one spouse having made a gift to the other. However, at the time such an agreement is entered into, it is probably not possible to value the amount of any resultant gift.[531] As a result, for gift tax purposes, annual gifts between the spouses may be recognized as the income is received. If such an agreement does not create any rights in third parties, presumably, such gifts would qualify for the marital deduction if both spouses were U.S. citizens. However, the IRS will not recognize for income tax purposes an agreement that converts income, but not the underlying property, from separate property to community property, and

[518] N.M. Stat. Ann. §40-3-8(B); Wash. Rev. Code §64.28.040.

[519] *E.g.*, Ariz. Rev. Stat. Ann. §33-431(C); Idaho Code §15-6-401; Cal. Civ. Code §682.1; Nev. Rev. Stat. tit. 10, §111.064; Wis. Stat. §766.60(4).

[520] *See Collier v. Collier*, 242 P.2d 537 (Ariz. 1952); *King v. King*, 107 Cal. App. 2d 257, 236 P.2d 912 (1951); *Greene v. Cooke*, 524 P.2d 176 (1973). Federal tax cases reached the same result. *Murphy v. Commissioner*, 342 F.2d 356 (9th Cir. 1965) (tenancy in common; Cal. law); Bordenave v. United States, 150 F. Supp. 820 (N.D. Cal. 1957) (joint tenancy property).

[521] *See* Rev. Rul. 69-505 (transfer of unilaterally severable joint tenancy property to irrevocable trust in which income was payable equally to trustors and to survivor of them resulted in gift to extent actuarial value of one spouse's interest in trust exceeded value of other spouse's interest).

[522] §2523(a).

[523] No gift tax marital deduction is allowable if the donee spouse is not a U.S. citizen. §2523(i).

[524] PLR 9218015.

[525] Idaho Code §15-6-201, §32-923; Tex. Estate Code §112.001; Wash. Rev. Code §26.16.120.

[526] Wis. Stat. §766.58(3)(f).

[527] *See* Wash. Rev. Code §26.16.120; *Neeley v. Lockton*, 389 P.2d 909 (Wash. 1964); *Harris v. Harris*, 60 Wash. App. 389, 804 P.2d 1277 (1991).

[528] 177 F.2d 114 (9th Cir. 1949).

[529] *See also Commissioner v. Mills*, 183 F.2d 32, 33 (9th Cir. 1950) (Cal. law).

[530] *Commissioner v. Mills*, 183 F.2d 32 (9th Cir. 1950); *In re Estate of Janssen*, 56 Wash.2d 150, 351 P.2d 510 (1960); *Venie v. United States*, 88-1 USTC ¶9106 (E.D. Wash. 1987); Rev. Rul. 73-390.

[531] *Cf.* Rev. Rul. 69-346.

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the spouses will not be able to split the income on separate returns.[532]

3. Disclaimers — §2518

Section 2518(a) provides that "if a person makes a qualified disclaimer with respect to any interest in property, this subtitle [the federal gift tax provisions] shall apply with respect to such interest as if the interest had never been transferred to such person." Under §2518(b), a qualified disclaimer must be written; must be received by the transferor, his or her legal representative, or the holder of title to the property, within nine months of the transfer (or in the case of a person under 21 years of age, within nine months of his or her 21st birthday); and the disclaimant must not have accepted the interest or any of its benefits.

Under §2518(c)(3), recognition is given to a disclaimer that satisfies the requirements of federal law even though it does not satisfy applicable state law. Thus, if the disclaimant gives written notice to the transferor of an interest (the transferor's legal representative or the holder of legal title in the property to which the interest relates) within the required time period without having accepted the interest or any of its benefits, the disclaimer will be recognized by the IRS regardless of whether it complies with local law. In some cases, disclaimers by the beneficiaries under a deceased spouse's will or trust resulting in the disclaimed interests passing to the surviving spouse by intestacy or otherwise, which would allow such disclaimed interest to qualify for the marital deduction.[533] In addition, a surviving spouse may disclaim the right to receive the deceased spouse's community property interest that would otherwise pass to him or her by intestacy, survivorship arrangement, or testamentary disposition.[534]

The surviving spouse, however, cannot disclaim property which he or she already owns, such as the surviving spouse's own interest in community property. A spouse can, therefore, only disclaim the decedent spouse's interest in community property. The applicable Treasury Regulations make this point clear:

> H and W, husband and wife, reside in state X, a community property state. On April 1, 1978, H and W purchased real property with community funds. The property is not held by H and W as jointly owned property with rights of survivorship. H and W hold the property until January 3, 1985, when H dies. H devises his portion of the property to W. On March 15, 1985, W disclaims the portion of the property devised to her by H. Assuming all other requirements of section 2518(b) have been met, W has made a qualified disclaimer of the interest devised to her by H. However, W could not disclaim the interest in the property she acquired on April 1, 1978.[535]

Prior to the enactment of §2518, an attempt to disclaim a surviving spouse's right to receive the decedent spouse's interest in community property as the decedent's heir was ineffective in some states.[536] Applying prior California law, a gift tax case decided by the Tax Court held that, while the surviving spouse could renounce the deceased spouse's community property interest left to him by will, the effect of his renunciation was to cause title to pass to him as the decedent's heir.[537] The court explained that the surviving spouse's disclaimer of his right to receive the interest as the decedent's heir was ineffective to prevent title from vesting in him. The court concluded that, title having been vested in him, his renunciation constituted a gift of the interest by him to the decedent's other heirs.[538]

For further discussion of disclaimers, see 848 T.M., *Disclaimers — Federal Estate, Gift and Generation-Skipping Transfer Tax and State Law Considerations.*

4. Prior Law Relating to Conversions into Separate Property

Prior to the adoption of the unlimited marital deduction,[539] no gift tax marital deduction was allowable with respect to transfers of community property.[540] Several cases arising under the pre-1982 law dealt with the tax consequences of transfers of community property between spouses. Some of these cases arose under the 1943–1948 law, under which the husband was treated as the donor of the entire value of gifts of community property.[541] Despite the implications of that rule, the cases generally held that the conversion of community property into equal amounts of separate property did not involve a gift to the wife. Some courts reasoned that there was no transfer.[542] Indeed, some courts continued to hold that if there "were such a transfer the property received by each is of equal value in money or money's worth."[543] This approach is also reflected in a 1955 ruling.[544] The rationale of the ruling would not apply to a conversion in connection with which one spouse received more than half of the community property.

C. Incomplete Transfers

1. Effect of State Law Restrictions on Transfer of Community Property

The gift tax applies only to "completed" transfers of any type of property. Accordingly, the general rules of Reg. §25.2511-2 regarding the completeness of gifts apply with equal force to transfers of community property. In some in-

[532] Rev. Rul. 77-359.

[533] PLR 9310020 (Cal. law).

[534] PLR 9218015. *See also* PLR 9507017 (surviving spouse's disclaimer, within nine months of decedent's death, of decedent's community property interest in property that passed to spouse at decedent's death under a Washington community property agreement was a §2518 qualified disclaimer).

[535] Reg. §25.2518-2(c)(5), Ex. (11).

[536] The result was appropriate if the title to intestate property passed to the decedent's successor automatically under local law without any opportunity to decline to accept it. *See Hardenbergh v. Commissioner*, 198 F.2d 63 (8th Cir. 1952) (Minn. law).

[537] *Maxwell v. Commissioner*, 17 T.C. 1589 (1952).

[538] See 848 T.M., *Disclaimers — Federal Estate, Gift and Generation-Skipping Tax and State Law Considerations*, for a detailed discussion of §2518.

[539] Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, §403(a)(1)(A), effective January 1, 1982.

[540] Former §2523(f), repealed by ERTA, Pub. L. No. 97-34, §403(b).

[541] *See* V.A.2., above.

[542] *E.g., Commissioner v. Mills*, 183 F.2d 32 (9th Cir. 1950) (Cal. law); *Beavers v. Commissioner*, 165 F.2d 208 (5th Cir. 1947) (Tex. law); *Plath v. United States*, 51-1 USTC ¶10,811 (E.D. Wash. 1950).

[543] *Commissioner v. Mills*, 183 F.2d 32, 34 (9th Cir. 1950) (Cal. law).

[544] Rev. Rul. 55-709 (1943–48 gift tax law).

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stances, state law may affect a determination of whether a gift of community property has been completed. For example, an attempt by one spouse to make a gift of community property to a third party without the consent of the other spouse may be incomplete in community property states such as California and Washington, which do not allow gifts of community property to be made by one spouse alone.[545] In other states, gifts of excessive amounts of community property may be void or voidable and potentially incomplete for gift tax purposes.[546]

2. *Transfers to Revocable Trusts*

Joint revocable living trusts are often used by married couples in community property states since community property is not divisible. Both spouses are the settlors and the beneficiaries while both are alive. Upon the death of the first spouse to die, the trust assets are divided into equal shares for each spouse's one-half share of the community property assets. Upon death of the surviving spouse, the trust will typically provide for distributions to third party beneficiaries. The transfer of community property into a revocable inter vivos trust in which third parties have beneficial interests raises issues of completeness. In TAM 8617006, the National Office advised that, if the power of revocation is reserved to both spouses, no transfer occurs: "The initial transfer of property by A into the trust during the joint lives of A and B was not a completed gift at the time of the transfer because the transfer was subject to revocation while both grantors were alive."

Spouses may prefer that any amendments or revocation require the joint action of the spouses, but such restrictions may create gift tax issues. Although a trust funded with only community property or otherwise jointly held property would not trigger a gift to either spouse, arguably the spouse with shorter life expectancy may be considered to be making a gift to the younger spouse. Reg. §25.2511-2(b) states that a gift is complete if the donor has no power to change disposition of the property, and Reg. §25.2511-2(e) provides that the donor is not considered to have retained the right to revoke if that right is exercisable jointly with a person who has a substantial adverse interest. If there was a gift from one spouse to the other, it would not qualify for the marital deduction because the donee spouse would only receive an interest if he or she survived the donor spouse (thus making it a terminable interest), and the donee spouse's interest would likely not qualify for the marital deduction as a qualified terminable interest because there is no right to all of the income.[547]

For community property states, the Uniform Trust Code (UTC) solves this issue by prescribing the following rule for revocation and amendment of a revocable trust holding community property:

> If a revocable trust is created or funded by more than one settlor:
>
> 1. to the extent the trust consists of community property, the trust may be revoked by either spouse acting alone but may be amended only by joint action of both spouses;
>
> 2. to the extent the trust consists of property other than community property, each settlor may revoke or amend the trust with regard to the portion of the trust property attributable to that settlor's contribution.[548]

Practice Tip: Regardless of whether this provision has been adopted in the particular state, a joint revocable trust agreement should contain comparable language. Another approach is to give each spouse the power to revoke or amend unilaterally but only with respect to their community property half. In practice, this would be difficult to carry out because revocation by one spouse alone would take out one-half of each asset then held in trust. If the trust is a California trust, a revocation provision in the agreement similar to the UTC is necessary to preserve the community nature of the assets.[549]

PLR 200101021 provides another potential approach. The trust in that ruling was a joint trust, funded by tenancy-by-the-entirety property owned by the grantors/spouses. Either grantor had the right to amend the trust, and either grantor had the power to terminate. Upon termination, the trust property was to be returned to the grantors as tenants-in-common. The IRS concluded that each grantor's power to terminate the trust and have their contributed property returned to them resulted in an incomplete gift.[550] Note, however, that each grantor in this case had made an equal contribution to the trust. If one spouse contributes a larger amount of assets to the trust, then each spouse must receive what they contributed to the trust to fall within the parameters of the letter ruling. Otherwise, there will be a completed gift upon the distribution to the non-contributing spouse; however, that gift would qualify for the marital deduction (assuming the recipient spouse is not a non-citizen) as long as either spouse could terminate the trust.[551] Therefore, the trust agreement should provide each spouse with the right to unilaterally terminate the trust, and, upon termination, the distribution of the property should be clearly articulated out in the trust agreement so as to ensure it aligns with the grantors' intent.[552]

The spouse who holds the power to terminate the trust is considered to hold it in a fiduciary capacity as agent for the community.[553] As a result, neither spouse is deemed to have made a gift until the trust becomes irrevocable — typically when one of the spouses dies.[554] On the other hand, it may be possible for one spouse to hold the power of revocation in an individual capacity (rather than in a fiduciary capacity). In this instance, presumably the gift by the spouse who does not hold a revocation power is completed as to half of the property transferred to the trust.[555] A subsequent distribution to a third party

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[545] Wash. Rev. Code §26.16.030(2); Cal. Fam. Code §1100; *Harper v. Commissioner*, 6 T.C. 230 (1946) (Cal. law).

[546] *Estate of Kelly v. Commissioner*, 31 T.C. 493 (1958) (La. law).

[547] *See* §2523(b).

[548] UTC §602(b).

[549] Cal. Fam. Code §761.

[550] Reg. §25.2511-2.

[551] Reg. §25.2523(e)-1(f)(6).

[552] *See* PLR 200403094, PLR 200210051.

[553] *E.g., Katz v. United States*, 382 F.2d 723 (9th Cir. 1967) (Cal. law); Cal. Fam. Code §761(b).

[554] *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958) (Tex. law).

[555] Reg. §25.2511-2(b). The power of revocation held by one spouse would cause his or her gift to be incomplete at the time the trust was created. However, it might have no such effect on the gift by the other spouse, who might be treated as having made a transfer to the spouse who held the power to revoke.

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may constitute a completed gift by the power-holding spouse as to half the distribution.[556] If the trust becomes irrevocable upon the death of the first spouse to die, then the surviving spouse will have made a gift of a one-half interest in the trust property less the value of the interests retained by him or her.[557]

D. Transfers of Community Property into Irrevocable Trusts

A transfer of community property to an irrevocable trust in which the spouses have reserved the right to receive the income for their joint lives should produce no gift tax consequences with respect to the income interest. In such a case, the value of each spouse's income interest during the spouses' joint lives should not be affected by the transfer. Similarly, a transfer of community property to an irrevocable trust, the income of which is payable to either spouse, should produce no tax consequences with respect to the income during the spouses' joint lives, assuming that the income distributions from the trust will constitute community income under applicable local law.[558] If the income of a trust funded with community property were payable to one spouse, the income would also most likely be characterized as community property. As a result, neither spouse would have made a gift of the right to receive income for the spouses' joint lives. The transfer of community property to an irrevocable trust may, or course, involve completed gifts by the spouses to the remainder beneficiaries.

In most community property states, income received during marriage from separate property is itself separate property.[559] A transfer of separate property by one spouse to an irrevocable trust to pay income to the other spouse for life, remainder to others, should be treated, for gift tax purposes, in the same manner as the transfer by one spouse of common law property in a common law state to a trust having the same terms. The result would be different in states, such as Idaho, Louisiana and Texas, where income received during marriage from separate property is treated as community property. In those states, a spouse who transfers separate property to an irrevocable trust of which the other spouse is entitled to the income for life would be treated as having retained an interest in one-half of the income for the duration of the other spouse's life. The value of the retained life estate would, of course, reduce the value of any gift made by the donor spouse.[560]

There is some debate over the characterization of grantor trust status when a couple transfers community property into an irrevocable grantor trust upon the death of the first spouse to die. During the lifetime of both spouses, each spouse has contributed one half of the trust property and is the deemed owner, for income tax purposes, to their respective half of the trust's assets.[561] Some commentators have argued that, due to the principles of community property and ambiguities in the Code and regulations, upon the death of the first spouse to die, the surviving spouse can be treated as the owner of the entire trust rather than the one-half he or she contributed to it.[562] Other commentators disagree, primarily on the basis of the wording of the Code and regulations, the basic community property principle that the undivided equal ownership of community property is not affected by applicable management powers or control, and the basic rule set out in the regulations that the taxpayer cannot be deemed to be the owner of assets that the taxpayer did not contribute to the trust.[563]

E. Consideration

1. In General

Any consideration received by the donor is taken into account in determining the amount of a gift. For gift tax purposes:[564]

> Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

In the case of transfers between spouses, the marital deduction is generally allowed with respect to the net amount transferred by one spouse to the other. For example, the IRS has ruled that the marital deduction is allowable with respect to the amount by which the value of a community property asset that was transmuted into the separate property of one spouse exceeded the value of another community property asset that was transmuted into the separate property of the other spouse.[565] Transfers between spouses may qualify for the unlimited marital deduction regardless of the separate or community character of the property transferred. In this instance, note that, under §1041 transfers between spouses do not involve any gain or loss unless the donee spouse is a nonresident alien.

2. Divorce and Annulment — §2516

Section 2516 largely eliminates the possibility that transfers of property incident to divorce being deemed a taxable gift. In a private letter ruling, the IRS found that the transfer of community property pursuant to a marital settlement agreement would not trigger gift tax even though §2516 was inapplicable.[566] According to the ruling, the transfer would not be subject to gift tax because the settlement agreement was incorporated into the divorce decree. Citing *Merrill v. Fahs*,[567] and §2043(b), the ruling explained that a spouse's release of marital property rights does not constitute consideration in money or money's worth. However, the ruling noted that, according to Rev. Rul.

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[556] *Fleming v. Commissioner*, 3 T.C. 974 (1944), aff'd on other issues, 155 F.2d 204 (5th Cir. 1946) (Tex. law).

[557] *E.g.*, TAM 8617006.

[558] *See Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958).

[559] *E.g.*, Cal. Fam. Code §770; Wash. Rev. Code §26.16.020–§26.16.030.

[560] For an example transfer, see Worksheets, below.

[561] *See* Reg. §1.671-2(e)(6), Ex. 3.

[562] *See, e.g.*, Jensen, *Continuation of Grantor Trust Status for an IDGT After the Death of One Grantor*, 50 Est. Plan. 25 (June 2023); Montgomery & Montgomery, *The Joint and Survivor Grantor Trust and the S Election*, 174 Tax Notes Federal 1815 (March 18, 2022).

[563] *See* Howard Zaritsky, Karen Boxx, Stevin Gorin and Ann Wilson, *Can the Surviving Spouse Own a Grantor Trust?*, 50 Estate Planning, No. 11, 8 (Nov. 2023).

[564] §2512(b).

[565] PLR 8929046.

[566] PLR 8744021.

[567] 324 U.S. 308 (1945).

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68-379, the release of support rights is consideration in money or money's worth.

3. *The Surviving Spouse's Election*

Under a traditional surviving spouse's election plan, the predeceasing spouse's would leave all of the community property to a trust from which the surviving spouse would have the right to receive the income for life if he or she elects to allow his or her interest in the community property to pass to the trust. Under a more modern approach, the decedent spouse would leave his or her share of the community property to a trust. The terms of the trust would require all income to be distributed to the surviving spouse if he or she transfers his or her share of the community property to the same trust, or to a separate trust that contains essentially the same terms. The children are usually the remainder beneficiaries of the trust or trusts. The surviving spouse is generally required to accept the plan in order to receive any benefit from the decedent spouse's share of the community property — other than, perhaps, interests in the spouses' residence and tangible personal property. The surviving spouse is treated as having purchased the predeceasing spouse's interest in the community property assets, the price of which equals the value of the remainder interest in the survivor's community property share.[568] The potentially favorable tax results are available only if the plan involves such a forced election. No advantage accrues if the surviving spouse retains a power over the disposition of his or her share of the community property that prevents his or her transfer from constituting a completed gift.[569] In a forced election, if the surviving spouse elects against the will, he or she will retain his or her half of the community property, will receive no benefit from the trust under the predeceasing spouse's will, and will have made no gift.[570] If the surviving spouse elects to take under the will, he or she must transfer his or her share of the community property to the appropriate trust.

a. *Prior Law*

Under the gift tax rules that applied prior to the October 9, 1990 effective date of Chapter 14, in a forced surviving spouse's election, the surviving spouse was deemed as having exchanged the remainder interest in his or her share of the community property for a life income interest in the decedent spouse's share.[571] Thus, the value of the gift made by the surviving spouse, if any, was determined by reducing the value of the property he or she transferred to the trust by the actuarially determined values of (1) the life interest retained in the property he or she transferred and (2) the life estate received in the decedent spouse's share of the property. In *Turman v. Commissioner*,[572] the Court found that no gift resulted because the value of the property the wife transferred was less than the value of the property she received (or retained). In considering the utility of a surviving spouse's election, planners often noted that the decedent spouse's share of the community property may be considerably smaller than the surviving spouse's share since the decedent spouse's share is often subject to a disproportionately large share of costs not chargeable to the surviving spouse's share, such as the estate and/or trust administration expenses. The potential difference in the size of the spouses' respective interests are considerations in both lifetime and postmortem planning. If the surviving spouse retained any substantial power over the property he or she transfers to the trust, the gift would be incomplete, per the gift tax rules.[573] The subsequent release of the reserved power would complete the gift. Unless the release was made at the time of the election, the transfer did not occur in consideration of the benefits conferred by the decedent spouse's will.[574]

b. *Current Law*

No gift or estate tax liability will result if the election only requires the surviving spouse to transfer to the trust an amount of his or her property, the total value of which is equal to the actuarially determined value of the life interest he or she is entitled to receive in the decedent spouse's share of the property. The use of such a "measured election" offers attractive transfer tax benefits, but involves substantial income tax uncertainties — particularly regarding the application and effect of §1001(e).[575]

Under §2702, the value of the surviving spouse's retained income interest is disregarded if the remainder in his or her share of the trust is transferred to "members of [his or her] family."[576] Thus, the surviving spouse would be treated as having made a gift of the entire value of his or her property less only the value of the life interest he or she received in the deceased spouse's share. For purposes of §2702, a family member is: (1) the transferor's spouse; (2) any ancestor or lineal descendant of the transferor or the transferor's spouse; (3) any brother or sister of the transferor; and (4) any spouse of the persons described in (2) and (3).[577] The operation of §2702 is described in regulations:[578]

> (b) *Effect of §2702* — If §2702 applies to a transfer, the value of any interest in the trust retained by the transferor or any applicable family member is deter-

[568] *See* John Price and Samuel Donaldson, *Price on Contemporary Estate Planning*, §9.23.

[569] *Robinson v. Commissioner*, 75 T.C. 346 (1980), aff'd, 675 F.2d 774 (5th Cir. 1982) (Tex. law). In *Robinson*, the widow held an inter vivos power to appoint the property she transferred to the trust to her children or to a charity. The court held that the transfer of her share of the property to the trust did not constitute a completed gift because of the power she retained over it. According to the court, the widow's release of the power of appointment completed the gift of the remainder, for which she received no additional consideration.

[570] *E.g.*, PLR 9310020.

[571] *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957) (Cal. law); *Turman v. Commissioner*, 35 T.C. 1123 (1961), acq., 1964-2 C.B. 7 (Tex. law). The widow's release of her income interest in part of the property from which she was entitled to receive the income constitutes a gift of the value of that interest to the remainder beneficiaries. *Commissioner v. Masterson*, 127 F.2d 252 (5th Cir. 1942) (Tex. law).

[572] 35 T.C. 1123 (1961), acq., 1964-2 C.B. 7 (Tex. law).

[573] Reg. §25.2511-2(c).

[574] *See Robinson v. Commissioner*, 75 T.C. 346 (1980), aff'd, 675 F.2d 774 (5th Cir. 1982) (widow's release of power of appointment over property she transferred to trust may result in completed gift of entire value of remainder interest in property).

[575] Planning considerations and variations on the surviving spouse's election, including a surviving spouse's election life insurance trust, are discussed in John R. Price & Samuel A. Donaldson, Contemporary Estate Planning (2016).

[576] §2702(a).

[577] §2702(e), §2704(c)(2).

[578] Reg. §25.2702-1(b).

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> mined under section §25.2702-2(b). The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property. If the retained interest is not a qualified interest …, the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property.

Note that the approach taken in §2702 in respect to retained interests other than qualified interests (fixed annuity or unitrust amounts) is in line with the approach taken in *Gradow v. United States*[579] and applied by the IRS: for estate tax purposes, the determination of whether the surviving spouse received full consideration for the property he or she transferred to the trust is made by comparing the total value of the property he or she transferred with the actuarially determined value of the life estate he or she received in the decedent spouse's share of the property. Thus, the same test will now be applied in typical surviving spouse's election cases for both gift and estate tax purposes.

In *Gradow v. United States*,[580] the estate argued that the widow's election fell within the full and adequate consideration exception of §2036(a), causing the value of the property she transferred to the trust to be excluded from her gross estate. The court disagreed, upholding the IRS's position that, if the surviving spouse makes a widow's election, the full date of death value of the entire property (less the value of consideration received) will be includible in the surviving spouse's estate unless the consideration equaled the fair market value of the interest in the property transferred to the trust (and not just the actuarial value of the remainder) at the time of the transfer. In other words, in evaluating whether a widow's election constituted full and adequate consideration for §2036(a) purposes, the consideration from the widow consisted of the property which would otherwise have been included in her gross estate by virtue of her retention of a life estate, her half of the community property.

Stating that the *Gradow* analysis would make the statutorily contemplated sale of a remainder virtually impossible, the Third Circuit rejected *Gradow's* reasoning in *Estate of D'Ambrosio v. Commissioner*,[581] and held that the sale of a remainder interest in property for an amount equal to its then actuarial fair market value succeeded in excluding the property from the decedent's gross estate.

Although *D'Ambrosio* did not involve a widow's election, the Court analyzed the widow's election situation in detail to demonstrate that the sale of a remainder interest for its actuarial value was not, as stated by the *Gradow* court, a tax-avoidance device. The court observed that, whether the widow keeps the half share of community property or sells the remainder at its fair market value, the same amount of property will be available for inclusion in her gross estate at death; if the income or life interest is insufficient. In either case the widow will have to invade principal or the consideration received for the remainder interest to the same extent. The Court concluded that there is no change in the date of death value of the interest, regardless of which option the widow selects, at any given standard of living. On the other hand, the Court noted, if the full, fee simple value of the property at death is pulled back in the gross estate under §2036(a), subject only to an offset for the consideration the widow received, then the post-sale appreciation of the transferred assets will be taxed at death. In fact, the Court stated, it will be double-taxed, because the consideration the widow received will also have appreciated and will be subject to tax on its increased value. In addition, the Court observed, it would appear virtually impossible, under the *Gradow* reasoning, to ever sell a remainder interest; if the adequacy of the consideration must be measured against the fee simple value at the time of transfer, the transferor will have difficulty finding an arms-length buyer willing to pay a fee simple price for a future interest.

The Fifth Circuit had the opportunity to analyze *Gradow* in detail in *Wheeler v. United States*,[582] as the IRS's position concerning adequate consideration for the sale of a remainder interest rested principally on an analogy to the widow's election mechanism. The Court in *Wheeler* concluded, however, that the widow's election cases present factually distinct circumstances that preclude the wholesale importation of the *Gradow* rationale into cases involving sales of remainder interests. The Court held that the sale of a remainder interest for its actuarial value was a sale for adequate consideration.

Adopting the above view of the Third and Fifth Circuits, the Ninth Circuit in *Estate of Magnin v. Commissioner*,[583] also held that "adequate and full consideration" was to be measured against the actuarial value of the remainder interest rather than the fee-simple value of the property transferred to trust by the decedent.

The old (pre-October 9, 1990) rules continue to apply to a transfer if the remainder beneficiaries are not members of the widow's (the transferor's) family.

c. *Income Tax Consequences*

Under ordinary rules, the sale by the decedent spouse's estate of a life interest to the surviving spouse might give rise to a gain — depending largely on whether the value of the decedent spouse's share of the property at the time of the surviving spouse's election had increased over its value for federal estate tax purposes. A substantial gain may occur if §1001(e) applies and the basis of the decedent spouse's estate is disregarded to the extent it is determined under §1014. In most circumstances the gain realized by the estate will be treated as capital gain and not ordinary income. The amount realized would be limited to the lesser of the actuarially determined value of the remainder interest or the value of the life estate transferred to the widow. Section 267 will prevent the seller from deducting a loss on the sale.

As the purchaser of a life interest in the decedent's share of the property, the surviving spouse was historically entitled to an amortization deduction for the cost of acquiring the in-

[579] 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990). *See* V.B., above.

[580] 897 F.2d 516 (Fed. Cir. 1990), aff'g 11 Cl. Ct. 808 (1987).

[581] 101 F.3d 309 (3d Cir. 1996), rev'g 105 T.C. 252 (1995).

[582] 116 F.3d 749 (5th Cir. 1997).

[583] 184 F.3d 1074 (9th Cir. 1999), rev'g and rem'g T.C. Memo 1996-25.

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terest.[584] However, the amortization deduction is now barred by §167(e) unless either (1) the transfer was made prior to July 28, 1989 or (2) the remainder beneficiaries are not related to the widow — the holder of the term interest. In other cases, the amortization deduction should remain available.[585]

F. Annuities

The transfer of an interest in certain joint and survivor annuities to a spouse who is a U.S. citizen qualifies for the marital deduction.[586]

G. Powers of Appointment — §2514

Neither the Code nor the regulations differentiates between the treatment given community property and separate or common law property for gift tax purposes. Depending upon the circumstances, the exercise, release, or lapse of powers of appointment may result in gifts being made by the power holder. In addition, as noted above,[587] the release of a power of appointment may constitute the completion of a previously incomplete gift of the remainder interest in a trust.

Under the prior law of some states, when wife's interest in the community property was considered a mere expectancy in some states, a wife had a power of testamentary disposition over community property in which she did not have a fully vested interest.[588] Although an estate tax regulation dealt explicitly with this type of property,[589] a similar provision was not included in the gift tax regulations. The estate tax regulation does not appear to have been involved in any published decision. For gift tax purposes, presumably the release of a post-1942 general power (i.e., a power which the holder could exercise in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate) would constitute a gift, to the extent the value of the property subject to the power exceeds interests retained by the holder.[590]

H. Life Insurance

1. In General

Relatively few decisions or rulings have dealt with the gift tax consequences of transactions involving life insurance policies which are community property in whole or in part. Most of the cases have involved Louisiana or Texas law — which differ materially from the laws of most other community property jurisdictions. Accordingly, in dealing with gift tax issues, close attention must be given to the local law.

A gift of community life insurance from one spouse to the other (to be held as the donee's separate property) is a gift of one-half the value of the property.[591] If the donee is a U.S. citizen, the gift will qualify for the marital deduction.[592] Consistently, a gift of a community life insurance policy by spouses to a third party is a gift of one-half by each spouse.[593] One spouse's use of community property to pay the premiums on a policy owned by the other spouse may involve a gift of the payor's one-half interest in the premiums to the spouse who owns the policy. In "apportionment" states such as California and Washington, such payments may create a community property ownership interest in the policy.[594] In "inception-of-title states" such as Louisiana and Texas, the payments may give rise to a right on the part of the community to recover the amount of premiums paid with community funds — but will not give rise to a community ownership interest in the policy.[595] The use by one spouse of community property to pay premiums on a policy owned by a third party should be deemed a gift by each spouse of half of the premiums; this result would, however, be subject to the nonpayor spouse's right to disavow the gift to a third party and recover his or her half of the premiums.[596]

In a revenue ruling, the IRS applied the "reciprocal trust doctrine" to a couple's purchase of cross-owned policies of insurance with community property funds.[597] In that ruling, the couple used community property funds to purchase identical policies, each of which listed the noninsured spouse as the owner and beneficiary. The IRS ruled that:

> [T]he presumption under Texas law that the policies are community property will prevail unless it is clearly shown that the transfers were not reciprocal and that gifts were intended. Accordingly, as a community asset, one-half the value of the property received as insurance on the life of the husband upon his death is includible in his gross estate under the provisions of §2042 of the Code. Furthermore, one-half of the value of the policy on the life of the wife is includible in his gross estate under §2033 of the Code as his interest in the community asset.

Practice Tip: It should be possible to avoid the problem raised in the ruling by clearly establishing the status of the policies and the premium payments. For example, the spouses could first convert funds to separate property of the owner spouse before using those funds to pay premiums. In the alternative, the policies could be acquired by the couple's children or by trusts of which the insured spouse was neither a trustee nor beneficiary.

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[584] *Estate of Christ v. Commissioner*, 54 T.C. 493 (1970), aff'd, 480 F.2d 171 (9th Cir. 1973) (Cal. law); *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1968), aff'd, 423 F.2d 1118 (9th Cir. 1970); *Kuhn v. United States*, 392 F. Supp. 1229 (S.D. Tex. 1975).

[585] Section 265 does not bar the amortization of the cost of acquiring an income interest in a trust that invests in securities that produce tax-exempt income. *Mfrs. Hanover Tr. Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970). In particular, §265, which denies deductions for otherwise allowable expenses of producing tax-exempt income, does not affect amortization deductions.

[586] §2523(f)(6).

[587] See the discussion of *Robinson v. Commissioner*, 75 T.C. 346 (1980), aff'd, 675 F.2d 774 (5th Cir. 1982), above, at V.D.3.

[588] *See* Elizabeth Carter, *The Illusion of Equality: The Failure of the Community Property Reform to Achieve Management Equality*, 48 Ind. L. Rev. 853 (2015).

[589] Reg. §20.2041-1(b)(1) provides: "If the community property laws of a State confer upon the wife a power of testamentary disposition over property in which she does not have a vested interest, she considered as having a power of appointment."

[590] §2514(b).

[591] *Perkins v. Commissioner*, 1 T.C. 982 (1943) (Tex. law).

[592] §2523.

[593] *Tidemann v. Commissioner*, 1 T.C. 968 (1943), acq., 1943 C.B. 23 (Tex. law).

[594] *Estate of Madsen v. Commissioner*, 650 P.2d 196 (Wash. Law). *See* IV.J.7.d., above.

[595] *See* IV.J.7.e., above.

[596] *See* V.C.1., above.

[597] Rev. Rul. 67-228 (Tex. law).

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As suggested above, transfers involving community property life insurance policies should be made with care and adequately documented. Ideally, each spouse should give written consent to the transfer of any policies and to the use of community property to pay premiums on policies owned by other parties. The nature of the evidence required to overcome the presumption favoring community property varies among the states.[598] In order to assure the effectiveness of a gift of the insured spouse's interest in a policy to the other spouse, the gift should be reflected in a document separate from the policy. It should include an express recitation that the policy is the separate property of the donee spouse and provide that the payment of subsequent premiums from community property will constitute gifts to the donee spouse and not create a community property interest in the policy.[599]

2. *Transfers by the Surviving Spouse upon the Death of the Insured*

The surviving spouse of the insured makes a gift of his or her community property interest in the proceeds of a policy to the extent the proceeds are paid to a revocably designated third party beneficiary. The gift tax regulations provide:[600]

> Where property held by a husband and wife as community property is used to purchase insurance upon the husband's life and a third person is revocably designated as beneficiary and under the State law the husband's death is considered to make absolute the transfer by the wife, there is a gift by the wife at the time of the husband's death of half the amount of the proceeds of such insurance.

The regulation was applied in *Cox v. United States*,[601] which held that the surviving spouse made a gift of half of the proceeds of community property life insurance policies on the life of her husband that were paid to third party beneficiaries. The position in the regulation was affirmed and elaborated upon in Rev. Rul. 53-232,[602] which stated that these gift tax consequences occur only in instances in which the designated beneficiary is someone other than the surviving spouse, or the "estate" of the decedent, and only when the policy is community property, in whole or in part.

These gift tax consequences were also discussed in two major court rulings. In *Commissioner v. Chase Manhattan Bank*,[603] the husband created a revocable inter vivos trust and funded the trust with insurance policies on his own life. The trust instrument provided that upon his death, the income was to be paid to his widow for her life, principal at her death to his descendants. At the husband's death, the Commissioner asserted that half of the proceeds of the insurance constituted a gift by the wife. After an extensive discussion of the nature of community life insurance under Texas law, the Court held that a gift, in fact, occurred. It concluded: "Under the terms of the agreement [the wife] was the income beneficiary for life. Accordingly, the measure of her gift was half the amount of the proceeds less a life estate in that half."[604]

In *Kaufman v. United States*,[605] the husband purchased policies on his life with community property funds, revocably designating his daughters as the beneficiaries of the entire proceeds of some policies and his wife as the beneficiary of the entire proceeds of other policies. When the husband died, his widow received a total of $175,000 in life insurance proceeds and the daughters received the entire $72,000 in life insurance proceeds. The Commissioner asserted that the wife had made a gift to her daughters of her one-half community property interest in the proceeds of the policies which were solely payable to her daughters. The Fifth Circuit disagreed on the grounds that the wife received more than half of the total proceeds:[606]

> To summarize, we hold that the rule of *Chase Manhattan* attributing one half of any bequest to others as a gift by a surviving spouse in a community property state must be limited to situations in which the surviving spouse receives less than his or her community share. Where that spouse receives his or her share or more there must be some evidence of donative intent in order to assess a gift tax.

The decision appears to be based on an application of the "aggregate theory" of community property, under which each spouse is entitled to half of the total value of the community property (or half the total value of a class of assets), and not half of each and every item of community property. Applying this rationale, the surviving spouse in *Kaufman* did not make a gift to her daughters because she received at least one-half of the total value of the life insurance. The decision is inconsistent with the "item theory" of community property that governs in most states, under which each spouse is considered to own an undivided one-half interest in each community property asset, such as the life insurance policies in the *Kaufman* case.

Note: Policy owners can avoid the *Kaufman* risk by designating third parties as beneficiaries of no more than half of any policy, which becomes must more simplified if the number of policies insuring the life of a spouse is limited. The possibility of a gift can be reduced, if not eliminated, if the third party beneficiaries disclaim the right to receive part or all of the proceeds, which could prevent the surviving spouse from making a gift. If the surviving spouse has not consented to the designation of the third party beneficiaries, no gift will occur if the survivor asserts the right to receive half of the proceeds of each policy.

In Rev. Rul. 94-69, the IRS ruled that where a Louisiana decedent used community funds to purchase an insurance policy on his life that was unconditionally owned by his surviving

[598] *See* IV.J.7., above.

[599] See the Worksheets, below, for a sample document.

[600] Reg. §25.2511-1(h)(9). Comparable language appears in the estate tax regulations — Reg. §20.2042-1(c)(5).

[601] 286 F. Supp. 761 (W.D. La. 1968).

[602] Rev. Rul. 53-232, *Exs.* A(1), D(1) (La. law). Rev. Rul. 53-232 was revoked by Rev. Rul. 94-69. The ruling states that "in Louisiana, if the insurance policy is the separate property of the surviving spouse who held all incidents of ownership including the power to change the designated beneficiary of the policy, the gift from the surviving spouse to the beneficiary becomes a completed gift of the total amount of the proceeds at the decedent's death." Continuing, the ruling states that if the policy is held by both spouses as community property, the payment of the proceeds to a third party is a gift of only the surviving spouse's half interest in the proceeds.

[603] 259 F.2d 231 (5th Cir. 1958) (Tex. law).

[604] 259 F.2d at 255.

[605] 462 F.2d 439 (5th Cir. 1972) (La. law).

[606] 462 F.2d at 442–443.

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spouse, the policy is the separate property of the surviving spouse. The IRS cited Reg. §25.2511-1(h)(9), but ruled that in this situation, an assignment of the benefits of the policy to a third-party designated beneficiary becomes a completed gift equal to the total amount of the proceeds at the decedent's death.

A spouse may have an obligation to provide life insurance coverage to cover alimony or child support payments for children from a prior marriage or relationship. If the spouse purchases a life insurance policy to cover alimony or child support obligations with community funds and then dies, the surviving spouse will have to claim his or her one-half of the proceeds to avoid the taxable gift, which would give the prior spouse or children, as applicable, a claim against the estate for the value of the obligation less one-half of the proceeds.[607]

I. Deductions

Two deductions are allowed in computing the gift tax: the charitable deduction and the marital deduction.

1. The Charitable Deduction — §2522

Little authority exists on the application of §2522 to community property. It would appear that a gift of community property by spouses to a qualified charity results in a gift tax charitable deduction for each. Because each spouse is making a gift of one-half of the donated property, in the case of some types of property (e.g., real property), the value of each spouse's gift and the corresponding charitable deduction may be discounted.[608] This issue holds more significance for the income tax charitable deduction. For example, spouses who make a gift of Blackacre, which is worth $250,000, may each be treated as making a gift of $125,000 less a discount resulting from the fractional nature of the gift made by each spouse. In this case, the problem can be avoided if one spouse gives his or her interest in Blackacre to the other spouse, who then donates the property to charity and values it at its full, undiscounted value.

2. The Marital Deduction

a. Current Law — §2523

The gift tax marital deduction is allowed for a transfer of community property. The deduction is available only if the transfer by one spouse to the other satisfies the qualified terminable interest rule.[609] In addition, no gift tax marital deduction is allowable if the donee spouse is not a U.S. citizen.[610] Instead, gifts from a spouse to a non-citizen spouse are subject to an annual exclusion applicable to gifts to a non-citizen spouse, adjusted for inflation.[611]

Practice Tip: Spouses who take advantage of making annual exclusion gifts to non-citizen spouses should exercise special care in selecting the donative property in order to limit the size of the donee spouse's estate that might be subject to the U.S. estate tax. For example, property that does not have a U.S. situs, such as shares of stock in foreign corporations and foreign real estate, would not be includible in the donee's gross estate.[612]

b. Prior Law

Prior to its repeal by the Economic Recovery Tax Act of 1981 (ERTA),[613] former §2523(f)(1) provided:

> A deduction otherwise allowable under this section shall be allowed only to the extent that the transfer can be shown to represent a gift of property which is not, at the time of the gift, held as community property under the law of any State, possession of the United States, or of any foreign country.

Thus, no marital deduction was allowable for a transfer of community property made prior to 1982. The rule applied to property that was community property at the time of the transfer or was separate property that had become community property. The application of the statute was elaborated in the regulations, which contained only one example of its application.[614]

ERTA[615] eliminated the quantitative limitations on gift and estate tax marital deductions and repealed the qualitative restriction which barred the marital deduction allowances for community property.

J. Registered Domestic Partners

With respect to California registered domestic partners, the vesting of half of the partner's earnings in the other partner does not result in a transfer for federal gift tax purposes under §2501. The IRS reasoned that, as the vesting occurred by operation of law, there was no transfer, whether deemed or otherwise, from one person to another of community earnings.[616] Among the community property states, California, Nevada, and Washington give registered domestic partners full community property rights.[617]

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[607] *Cf., e.g.,* Wash. Rev. Code §48.18.440 (presumption of consent of spouse to naming a child, parent, or sibling as beneficiary, thus creating a gift of the survivor's one-half interest).

[608] *See* VII.C., below.

[609] §2523(F).

[610] §2523(i).

[611] §2523(i)(2), cross-referencing §2503(b). For current and historical inflation-adjusted amounts under §2523(i), see *Gift Tax Annual Exclusion for Gifts to Non-Citizen Spouses* in Tax Tables, Charts and Lists (Federal).

[612] For further details, *see* 845 T.M., *Gifts*.

[613] Pub. L. No. 97-34, §403(b).

[614] Former Reg. §25.2523(f)-1(b)(5).

[615] Pub. L. No. 97-34, §403.

[616] PLR 201021048.

[617] Cal. Fam. Code §297.5; Nev. Rev. Stat. §122A.200; Wash. Rev. Code §26.60.660.

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VI. The Generation-Skipping Transfer (GST) Tax

A. General Rules

A generation-skipping transfer tax is imposed on three types of transfers: (1) a direct skip from a transferor to a skip person such as a grandchild (i.e., a person in a generation which is two or more generations below the transferor's generation); (2) a taxable termination (the termination by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless immediately afterwards a nonskip person has an interest in the property or at no time thereafter may a distribution be made to a skip person; and (3) a taxable distribution (a distribution from a trust to a skip person which is not a taxable termination or a direct skip).[618]

Transfers involving community property are subject to the same GST tax rules as transfers of common law property. In the case of an inter vivos transfer of community property to a third party, presumably, the GST tax treatment will mirror the established gift tax rules. Thus, each spouse would be treated as the transferor of one-half of a gift of community property.[619] For example, each grandparent would be treated as the transferor of one-half of a gift of community property made by the grandparents to a grandchild whose parents were living at the time of the gift. Such a transfer would be a direct skip.

B. Effect of the Surviving Spouse's Election

The application of the GST tax is more complex in cases involving a forced surviving spouse's election. However, the probable results are obtained by meshing established gift and estate tax principles with GST tax rules. The GST tax should be applied to a surviving spouse's election in the following manner.[620]

1. Transferor

If the surviving spouse receives full and adequate consideration for the amount transferred by the survivor into the trust, then the decedent should indirectly be the grantor of the trust funded by the survivor's one-half of community property and would be considered the transferor of both remainder interests for GST tax purposes. If the survivor is not deemed to have received full and adequate consideration, then the survivor would presumably be the transferor only to those assets transferred to the trust. The decedent spouse should be treated as the transferor of property that is distributed from his or her estate to the trust and the surviving spouse should be treated as the transferor of property that is transferred from him or her to a trust.

2. Allocation of Exemption; Estate Tax Inclusion Period; Inclusion Ratio

The decedent spouse's executor could allocate part or all of the deceased spouse's GST tax exemption to the transfer from his or her estate to the trust. The estate tax inclusion period rule of §2642(f) would prevent the surviving spouse from allocating his or her GST tax exemption to any property he or she transferred to the trust to the extent the property would be includible in his or her estate should he or she die after the transfer. The surviving spouse's transfer is subject to inclusion under §2036 unless he or she received full and adequate consideration. Note that none of the property transferred by the surviving spouse would be includible in his or her estate if its total value does not exceed the actuarially determined value of the life interest he or she receives in the property transferred by the decedent spouse.[621] In this case, the surviving spouse should be allowed to allocate her GST tax exemption to the transfer on a gift tax return filed for the year in which the transfer was made.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act)[622] provided that, for timely and automatic allocations of the GST tax exemption after December 31, 2000, the value of the property for purposes of determining the inclusion ratio, is the property's final gift or estate tax value, depending on the circumstances of the transfer and, in the case of a GST tax exemption deemed to be made at the conclusion of an estate tax inclusion period, the value of the property in determining the inclusion ratio is the property's value at the time.

3. Valuation of Property

The extent to which the consideration received by the surviving spouse will be taken into account is not entirely clear. On the one hand, §2642(b)(1) provides that the valuation of the property for purposes of determining its inclusion ratio is its gift tax value. Thus, the surviving spouse would have to argue that his or her transfer should be valued according to its "net" value, which might be zero. On the other hand, under §2624(d), "the value of the property transferred shall be reduced by the amount of any consideration provided by the transferee." The IRS will, no doubt, argue that the latter requires that the property transferred be valued without taking into account the consideration received from anyone other than the ultimate transferees. If the surviving spouse prevails, presumably, he or she would only allocate $1 of his or her GST tax exemption in order to insulate the entire value of the property he or she transferred to the trust from application of the GST tax. Overall, it is doubtful that the use of the surviving spouse's election will generate any substantial GST tax savings.

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[618] For a detailed discussion of the generation-skipping transfer tax rules, see 850 T.M., *Generation-Skipping Transfer Tax (Chapter 13).*

[619] *See* Reg. §25.2511-1(h)(9).

[620] The following discussion is based on John R. Price & Samuel A. Donaldson, Contemporary Estate Planning (2016).

[621] *See Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), rev'g 105 T.C. 252 (1995) (rejecting reasoning and conclusion of *Gradow* (cited below) and holding that sale of remainder interest in property for its actuarial fair market value fell within §2036(a) exception for transfers for full and adequate consideration and, thus, property was not included in decedent's gross estate). *See also Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999), rev'g and rem'g T.C. Memo 1996-25. In *Gradow v. United States*, 897 F.2d 516 (Fed. Cir. 1990), aff'g 11 Ct. Cl. 808 (1987), the court held that in the widow's election situation, the property's value that the widow transferred to the trust will be included in the widow's gross estate unless the consideration she received equaled the fair market value of the fee simple interest in the property at the time of the transfer. For further discussion, *see* V.D.3., above.

[622] Pub. L. No. 107-16, §563, amending §2642(b). The American Taxpayer Relief Act of 2012 (ATRA), generally made permanent the EGTRRA provisions. Pub. L. No. 112-240, §101.

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VII. Valuation

Several special rules apply to the valuation of property for transfer tax purposes. The divided ownership of community property has caused some complexity in the application of the gift, estate and generation-skipping transfer taxes. It has, at the same time, created some opportunities — particularly regarding valuation of assets.

A. *Valuation Setoff Under §2043; Application of Actuarial Tables*

In the case of a forced surviving spouse's election,[623] the property transferred by the surviving spouse is includible in his or her gross estate unless he or she received full and adequate consideration at the time of the transfer. If he or she did not make the election, the property of which he or she made a lifetime transfer is includible in his or her estate, valued as of the federal estate tax valuation date applicable to his or her estate. Under §2043, an offset is only allowed for the actuarial value determined at the time of the original transfer of the life estate the surviving spouse received in the deceased spouse's net share of the community property. This "frozen dollar" approach can operate to the serious disadvantage of the surviving spouse's estate.

In *Estate of Simmie v. Commissioner*,[624] the Tax Court held that the determination of whether the surviving spouse received full and adequate consideration must be determined according to the actuarial tables in effect at the time of the transfer. As a result, the value of the property he or she transferred to the trust at the time of the surviving spouse's death was compared with the value of the life estate he or she received in the decedent spouse's share of the community property — valued at the time of the surviving spouse's original election. The valuation would then be made according to the interest rate applicable for the month in which the transfer was made in accordance with §7520.[625]

Simmie involved former Reg. §20.2031-10(a)(1), under which the valuation of term and life interests, annuities and remainders of "decedents dying after December 31, 1970 and before December 1, 1983" were valued according to 6% actuarial tables. The decedent's estate argued that, as decedent died on February 25, 1971, the 6% tables should apply in determining the sufficiency of the consideration she received. The Tax Court disagreed, holding that the valuation of the consideration received by Mrs. Simmie must be valued according to the 3 1/2% actuarial tables that were in effect at the time she transferred her interest in the community property to the trust. According to the Tax Court, "to hold for petitioner would do harm to the concept that the estate tax and gift tax are designed to work in harmony."[626]

[623] *See* V.D.3., above.

[624] 69 T.C. 890, *aff'd*, 632 F.2d 93 (9th Cir. 1980) (Cal. law).

[625] Reg. §20.7520-1(a) (referencing Reg. §20.2031-7 for estates with valuation dates on or after June 1, 2023 and Reg. §20.2031-7A for estates with valuation dates before June 1, 2023); T.D. 9974, 88 Fed. Reg. 37,424 (June 7, 2023) (amended regulations to reflect updated mortality data from 2010 census). The IRS provides the actuarial tables online at https://www.irs.gov/retirement-plans/actuarial-tables. Examples using the actuarial factors can be found in IRS Pub. 1457, Actuarial Valuations Version 4A, and IRS Pub. 1458, Actuarial Valuations Version 4B.

B. *Special Use Valuation — §2032A*

Under §2032A(e)(10), if the decedent and the decedent's spouse held qualified real property as community property, the surviving spouse's interest in such property must be taken into account to the extent necessary to provide a result which is consistent with the result which would have been obtained had the property been common law property. "To achieve this result, a decedent's community property interest is to be treated as if owned by the decedent as an individual."[627] Thus, a deceased spouse's one-half community property interest in qualified real property can be reduced by the full amount allowed by §2032A(a)(2).

C. *Minority and Fractional Interest Discounts*

For transfer tax purposes, a minority interest in the stock of a corporation with a single class of stock qualifies for a discount.[628] In Rev. Rul. 93-12, the IRS concluded that it was appropriate to allow a minority discount even though the rest of the stock was held by members of the transferor's family:

> [T]he Service has concluded that, in the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.

Under this approach, the valuation of one spouse's interest in community property stock cannot include a control premium, nor could one spouse be deemed a controlling shareholder for the purpose of attributing ownership of a corporate-owned policy of life insurance under Reg. §20.2040-1(c)(6). Indeed, as indicated below, if any stock is held by others, a spouse's one-half community property interest will be subject to a minority discount.

In *Estate of Lee v. Commissioner*,[629] the Tax Court held that the deceased spouse's one-half interest in an 80% block of stock that she and her husband owned as their community property must be valued as a 40% minority interest:[630]

> We believe the block of 4,000 shares of common and 50,000 shares of preferred constituted an item of community property in which Mr. and Mrs. Lee each had an undivided one-half interest which was equivalent to each having a separate interest in a block of 2,000 shares of common and 25,000 shares of preferred. Although in the aggregate the marital community held a majority interest in the stock of Palin Trucking, for estate tax valuation purposes each held a separate minority interest.

The Tax Court explicitly rejected the government's argument that the decedent's interest in the stock should be valued as one-half of a control block of 80%. The Fifth Circuit reached

[626] 69 T.C. 890, 894.

[627] Rev. Rul. 83-96.

[628] For a detailed discussion of valuation of stock, see 831 T.M., *Valuation of Corporate Stock*.

[629] 69 T.C. 860 (1978) (Wash. law), *acq.*, 1993-1 C.B. 202.

[630] 69 T.C. 860, 874.

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the same result a few years later in *Estate of Bright v. United States*,[631] a case that involved the valuation of the decedent's one-half interest in a community property block of 55% of the stock in several corporations.

Propstra v. United States,[632] a 1982 Ninth Circuit decision, upheld the allowance of a 15% discount in valuing the decedent's undivided one-half interest in real property owned by the decedent and his surviving spouse as their community property. Concluding that "the undisputed evidence indicates that the value of the interest held by the estate [the decedent's share of the community property] was less than that interest's proportionate value of the whole," the Court affirmed a summary judgment in favor of the decedent's estate.[633] The potential availability of a fractional interest discount may well encourage couples to utilize a community property form of ownership. The Tax Court has ruled that no fractional interest discount or lack of marketability discount is available for California real property held by the spouses as joint tenants with right of survivorship, where the surviving spouse, who did not speak English, could not rebut the presumption created by record title by showing that the property was community property.[634]

[631] 658 F.2d 999 (5th Cir. 1981) (*en banc*) (Tex. law).
[632] 680 F.2d 1248 (9th Cir. 1982) (Ariz. law).
[633] 680 F.2d 1248, 1253.
[634] *Estate of Young v. Commissioner*, 110 T.C. 297 (1998).

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- Internal Revenue Manual Excerpt: Section 25.15.5.1 et seq., Special Topics; Relief from Joint and Several Liability; Relief from Community Property Laws/Community Property States.
- Internal Revenue Manual Excerpt: Exhibit 25.18-1 Comparison of State Law Differences in Community Property States.
- IRS Publication 555, Federal Tax Information on Community Property (rev. Feb. 2016). Publication 555 is available on IRS's Website at http://www.irs.gov/pub/irs-pdf/p555.pdf.
- Internal Revenue Manual 25.18.2 Income Reporting Considerations of Community Property.

Useful Websites

Internal Revenue Service — *www.irs.gov.*
Alaska State Legislature — *http://www.legis.state.ak.us/basis/folio.asp.*
Arizona State Legislature — *http://www.azleg.gov/arstitle/.*
California State Legislature — *http://leginfo.legislature.ca.gov/faces/codes.xhtml.*
Idaho State Legislature — *https://legislature.idaho.gov/statutesrules/idstat/.*
Louisiana State Legislature — *http://www.legis.la.gov/legis/LawSearch.aspx.*
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