Price & Farrington's Estate and Tax Planning *Fast* Faxts

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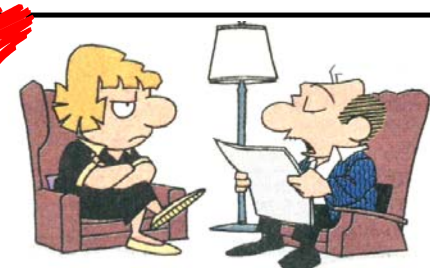
Estate, Tax, Retirement and Wealth Preservation Planning

Price & Farrington
Attorneys and Counselors at Law
12501 Bellevue-Redmond Road, Suite 215
Bellevue, Washington 98005
425-451-3583
Email: pricefarr@aol.com

Smart Tax Planning in Community Property States: Proceed With Caution

Happy Valentines Day to community property lovebirds!



"Okay, you've given me the best years of your life. What do you want...a receipt?"

Let's bone up on an important area of estate planning for many folks…

More than 30% of Americans live in community property states, where the rules are very different than in "common law" states. The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, *Washington* and Wisconsin.

Community property. In these states, all property acquired during a marriage, except through gifts or inheritance, is considered to be community property. Regardless of how such property is titled, it is presumed to be owned fifty-fifty by the marital partners. (Although rules differ among community property states, this is essentially the law.)

Example: Dan and Daisy Doe live in Seattle. Dan earns substantial income. Daisy is a homemaker raising three screaming brats. Dan buys a commercial office building in Pioneer Square with his business earnings and holds the property in his own name. Nevertheless, half of the building is considered to belong to Daisy.

Tax advantage. Assume the building has a $1 million value at the time of Dan's death. Only half of the property ($500, 000) will be included in his taxable estate. And Dan can bequeath only half the property. Suppose that in his living trust Dan leaves the building to his nephew. Regardless of Dan's wishes, this bequest can cover only half the property. The other half remains Daisy's. This law applies for estate tax purposes. For income tax purposes, the entire property gets a step-up in basis to current value.

Example: Dan dies when the property is valued at $1 million. Assume that the building has been fully depreciated. A sale before Dan's death would have generated a $1 million taxable gain. Under current law, inherited property gets a new basis – the market value as of Dan's date-of-death.

In most states, only half of jointly owned property (the half passing from the decedent) would get a basis step-up. But in a community property state, the *entire property* gets a basis step-up – even Daisy's half, which has not changed hands. Result: If the property is sold for $1 million, neither Dan's nephew nor Daisy would owe taxes on the sale. The same result would have applied if Daisy had inherited Dan's interest in the property. It would also have applied if Daisy had died first and left her half of the property to Dan, or to a third party.

Caution: Under the 2001 Taxpayer Relief Act, some heirs will lose the advantage of this basis step-up for deaths occuring in 2010 under a *carryover basis* regime to take effect that year. Many observers, however, doubt this change in the law will ever take place.

IRA issues: In community property states, an IRA belongs not just to the participating spouse, but to the married couple.This may cause some challenges for tax planning, especially for couples with (1) estates large enough to trigger tax, (2) large IRAs or (3) few liquid assets to tap in order to pay estate tax.

Example: Will Gate had a successful career as a corporate executive in Redmond, Washington. He retired with $3 million in his software company retirement plan, which he rolled over to an IRA. He and his wife, Melissa, have few other substantial assets but own a small Lake Washington house valued at $600,000. If either of them dies in 2002 or 2003, up to $1 million worth of assets can be left to their children tax-free. Not using this applicable exclusion amount would waste a valuable tax break.

Trap: Will's IRA is the only asset available to soak up the $1 million estate tax exclusion. Since the interplay between community property laws and the Tax Code is unclear in this area, Will should see an experienced advisor to optimize his tax planning.

Solutions: One approach is for part of Will's IRA to be left to a properly drafted "bypass trust," with Melissa and their two children as beneficiaries, thus removing assets from the survivor's estate while still allowing her access to the funds. Leaving an IRA to a bypass trust, however, means the possibility of lack of control, a loss of long-term tax deferral and income tax complications.

Better: Will can name Melissa his IRA beneficiary, and Melissa can leave *her* community property interest in Will's IRA to Will. In both cases, a bypass trust can be named as contingent beneficiary. A similar arangement can be made for their small Lake Washington house. After the death of the first spouse, the survivior can decide how much of the inherited community property to retain and how much to *disclaim* in favor of the bypass trust. Remember: a disclaimer must be made within nine months and executed properly or it will be invalidated. The survivor can weigh all of the circumstances to make an informed decision.

Property Agreement: In some states, such as Washington, a married couple's assets are *presumed* to be community property. So is any income earned by either spouse. To achieve valid estate planning goals, the couple might choose to alter this legal presumption by entering into a carefully drawn contract–a property agreement. Careful: strict rules must be followed in order to make the agreement enforceable. *Community property laws and their affect on estate and tax planning can be complicated. Always consult an experienced estate planning attorney.* ■