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You Probably Need a Community Property Agreement

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This is a series of a periodic discussions of financial issues affecting physicians.

We explained in last December's *Lifeline* why the Roth IRA is a stupendous intergenerational wealth transfer vehicle. We thought that we would follow-up with a practical discussion of estate planning with pension assets and why married couples probably need an agreement defining how California pensions are to be allocated between the decedent and the surviving spouse.

You probably know that the income tax on appreciated securities or real estate is forgiven at death. That is, the tax cost for income tax purposes is "stepped-up" to fair market value at death.

> Two physicians own a medical building as tenants in common. One dies. Half of the tax cost of the building is increased to fair market value; the other half is unchanged.
>
> Husband and wife own their home as joint tenants. One half of the tax cost is stepped up to fair market value on the death of either spouse; one half is unchanged.
>
> Husband and wife own their home as community property. The entire tax cost is stepped-up to fair market value on the death of either spouse.

The double step-up provides a strong income tax incentive to own securities and real estate as community property. If you want to insure that the property passes automatically to the surviving spouse without probate, and you have chosen to not create a living trust, you will be pleased to know that California real estate can be owned as "community property with right of survivorship" and securities can be owned as "community property transferable on death." These new forms of ownership provide Californians both a double step-up and automatic transfer to the surviving spouse.

Pensions are not stepped up to fair market value on death. This is of no consequence to the Roth IRA since distributions are income tax free.

We often create trusts at death to control the ultimate disposition of our assets, to provide for a younger or disabled heir or to claim the marital deduction when the surviving spouse is not a U.S. citizen.

Married couples also use trusts is to save estate tax at the death of the surviving spouse. For example, a trust can reduce the valuation of a medical practice or personal residence at the second death[1]. More commonly, a

[1] This principle was established in *Mellinger,* AOD 1999-006. A business was valued at a discount because part was owned by the surviving spouse and part by a QTIP trust. A personal residence split

married couple will create a "bypass trust." The surviving spouse is not considered to own the assets in this trust, and therefore the assets are not included in the estate at his or her death, because the surviving spouse can only access the trust's assets to satisfy their needs; he or she is denied access to satisfy their wants.

Bill and Sue own their million dollar home and million dollars of securities.

> They transfer the home and securities to a living trust, retaining the character as community property. The trust includes language that says that a million dollars from Bill's half of the trust assets are to be transferred to the bypass trust (assuming Bill dies first) with the balance to Sue. There is similar language creating a bypass trust for Bill's benefit if Sue dies first. There is also language allowing the trustee to chose the home or securities or any combination when selecting assets to fund the bypass trust[2].
>
> At the first death, the trustee funds the bypass trust with the securities and transfers ownership in the home to the surviving spouse. The securities provide security for the surviving spouse but they are not taxed again at the second death.

There are difficulties with this estate plan when ownership of some assets are automatically transferred at death. Suppose, for example, that Bill and Sue owned their million dollar home as community property with right of survivorship and the million dollars of securities as community property in a living trust.

> Bill dies and his share of their home passes to Sue. As before, the trustee funds the bypass trust with half of the trust assets. However, the trust assets are less than if the living trust had owned the home and therefore less money passes to the bypass trust. Part of Bill's exclusion amount is wasted and there might be estate tax at the second death.

This example is artificial since the solution, transfer the home to the living trust, is obvious, low cost and effective. However, exactly the same difficulty occurs when an IRA or pension is an important part of a family's wealth since ownership of the IRA or pension automatically transfers to the named beneficiary at death and this asset is not available to fund the bypass trust.

One solution is to make the couple's joint living trust the primary beneficiary[3] the pension or IRA. Assume a million dollar home is owned by the trust and a million dollar IRA owned by Bill.

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between the surviving spouse and a bypass trust also creates a discount. However, a trust controlled by the surviving spouse does not create a discount; see *Estate of Fantana (2002)*, 118 TC 16.

Valuation discounts are not attractive unless there will be estate tax at the second death because discounts reduce the step-up in the income tax cost at the second death.

[2] A non pro rata allocation cannot create a federal income tax liability because such allocations are authorized by California law.

[3] For more on this strategy see, Natalie Choate's "Life and Death Planning for Retirement Benefits," 4th Ed., 2002. This book can be purchased at www.ataxplan.com.

Bill dies and his IRA passes to the trustee of the living trust. Sue, in her capacity as the trustee, allocates the home to the bypass trust and the IRA to herself. Sue, in her capacity as the trustee, then distributes the IRA to the surviving spouse, who renames the IRA as her own.

This strategy ends up with full funding of the bypass trust and the surviving spouse owning the IRA with the ability to continue to defer distributions until her death. The IRS has issued private letter rulings that suggest that this scenario is copacetic so long as the surviving spouse is trustee and has exclusive control over the IRA allocation and so long as the transfers occur before September 30 of the year after Bill's death.

Private rulings do not bind the IRS except with respect to the person who requests the ruling. The obvious risk is that the IRS might change its mind about rolling the pension out to the surviving spouse. Other risks are that the surviving spouse might be incompetent and unable to effect the rollover or that the poor spouse might die first or the time deadline might be missed. But the biggest drawback is that the IRA custodian may balk at the required transfers.

This and other solutions also fail if the IRA is owned by one spouse and the poor spouse dies first. For example, if Sue should predecease Bill.

The best solution is for Bill and Sue to agree that each owns half of the home and pension in aggregate and that the first to die owns the home as their share of the community property and that the survivor owns the IRA as their share.

Bill dies and his IRA passes to Sue because he has named her as his beneficiary. By virtue of a community property agreement, the home is Bill's share of the community assets. The trustee can use the entire value of the home to fund the bypass trust for Sue's benefit.

Alternatively, Sue dies first. Bill continues to own the IRA. By virtue of a community property agreement, the home is Sue's share of the community assets. The trustee can thus use the entire value of the home to fund the bypass trust for Bill's benefit.

Community property agreements are evolving law and could be in conflict with federal ERISA legislation and certain provisions of California law. Your attorney should be able to draft an agreement to avoid these difficulties[4].

A community property agreement provides maximum funding of the bypass trust and ownership of pension assets by the surviving spouse. It removes the threat that the surviving spouse might not be competent to act or that the IRS might change its mind or that the wrong spouse might die first. And you don't need the cooperation of your pension provider.

Next time, how the President's proposed pension changes might effect younger physicians. We welcome your suggestions for future topics.

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[4] See Steve Trytten's "How To Draft The Estate Planning Documents To Effectively Handle Retirement Plan Distributions" at www.iracaddie.com/SCTEPMarch2002a.pdf.

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