The Wealth Counselor

A monthly newsletter for wealth planning professionals

Income Tax Planning with Alaska Community Property Trusts

Volume 8, Issue 4

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The Duvall Law Firm believes in taking the "team approach" to estate & business planning. Providing effective, responsible service to our clients leads us to build and maintain relationships with clients' professional advisors. Cooperation is the cornerstone of our relationships with both advisors and the clients we serve together.

The Internal Revenue Code ("IRC") provides substantial income and estate tax benefits to the married residents of the nine "community property" states. A tenth state – Alaska – allows married couples to opt in to the community property regime and reap these benefits. In addition, Alaska offers the married residents of the other 40 states a way to reap these benefits by using its community property law.

This simple income and capital gains tax planning trust strategy is one that advisor teams in those 40 states can use to distinguish themselves from other advisors and bring real value to their clients.[1] While this strategy has been underutilized in the 15 years since the Alaska Community Property Act was passed, the recent changes in income and capital gains tax rates have made it especially valuable.

In this edition of *The Wealth Counselor*, we will review the 2013 changes to the federal income and capital gains tax laws, explain community property law basics and tax benefits, explain how an Alaska Community Property Trust works, and identify some appropriate applications.

The Problem of Capital Gains Tax

Clients hate to pay capital gains tax to the point that they sometimes put themselves at risk to avoid this tax. Portfolios become unbalanced

or over-weighted in one or two stocks because clients refuse to sell. Elderly clients are tired of managing rental real estate but won't sell the property because of the capital gains tax.

Current Capital Gains Tax Rates

Under the Taxpayer Relief Act of 2013 and the Patient Protection and Affordable Care Act of 2010, the capital gains problem is much worse in 2013 for high income taxpayers. Here are the 2012 and 2013 capital gains tax rates for married couples filing jointly:

Adjusted Gross Income	2012 Rate	2013 Rate
$250,000 to $450,000	15%	18.8%
Over $450,000	15%	23.8%

Add State Capital Gains Tax

Several states now have their own capital gains tax. For example, Iowa's is 8.98%; Hawaii's is 11%; New Jersey's is 8.97%. Alaska does not currently have a state capital gains tax.

Add Recapture of Depreciation

For depreciated property, a 25% tax rate will apply to recaptured depreciation. The 3.8% Medicare surtax will also apply to recaptured depreciation if the couple has adjusted gross income of more than $250,000.

Example: John and his wife Mary own an apartment building in Illinois that they purchased for $1 million in 1978. It is now worth $10 million. If they sell it, they will have a gain of $9 million. The property has a depreciated basis of zero, so they will also have $1 million of depreciation recapture. They have more than $450,000 in other income. Here's what will happen if they sell their apartment building and why they may not want to:

20% Federal capital gains tax (on $9 million)	$1,800,000
25% Depreciation recapture tax (on $1 million)	250,000
3.8% Medicare surtax (on $10 million)	380,000
5% Illinois capital gains tax (on $10 million)	500,000
Total Tax	$2,930,000

The Hold Until Death Strategy

IRC Section 1014 provides that the basis of property acquired from a decedent that is included in the decedent's estate for estate tax purposes is its fair market value at 1) the date of the decedent's death or 2) optionally in a few cases, six months after the date of the decedent's death. Generally, this results in a "step up" in basis as most property appreciates in value over time due to the effect of inflation. (A "step down" in basis occurs if the market value goes down instead of up between acquisition and death.)

Planning Tip: Many people are tempted to hold onto appreciated property until they die so their children will get the step up in basis.

Example Variation #1: Assume that John is the sole owner of the apartment building and leaves it to Mary upon his death in 2013. Under IRC Section 1014, Mary receives a "step up" in basis to $10 million, the fair market value of the property. If Mary then sells, there is no tax on the gain or depreciation recapture – a tax savings of more than $2.9 million.

Example Variation #2: Assume John and Mary own the building jointly and John dies. IRC Section 1014 provides Mary a "step up" in basis on John's half of the property to $5 million. Added to Mary's basis on the other half, that results in a new basis for Mary of $5 million. Upon sale by Mary at $10 million, capital gains tax and recapture is still over $1.4 million.

Community Property

Community property states have marital property laws that were derived from Spanish or French law whereas the "common law" states' marital property laws were derived from English law. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. In 1998 Alaska adopted a law that allows a married couple to opt in by written agreement to the community property regime.

Each state's community property law is slightly different from those of the other community property states, but, in general, a community property regime is similar to a partnership. Each spouse has a one-half undivided interest in the community property, so the property is held as a whole and cannot be divided into his/her shares.

Death Basis Adjustment of Community Property

IRC Section 1014 also provides a special rule for any community property owned by the decedent and the decedent's spouse. For such property, the IRC Section 1014 basis adjustment applies to both the

decedent's interest in the property and the "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state or possession of the United States."

Here's how that works:

Example Variation #3: Assume John and Mary own the building as community property. When John dies, the property will receive a *full* "step up" in basis for Mary to fair market value of $10 million. If she sells it at $10 million, there will be no capital gains tax. Community property treatment thus saves about $1.4 million in capital gains tax. If Mary doesn't sell, she can depreciate the property's improvements at its new basis of $10 million minus the value of the land.

Planning Tip: *The result is that appreciated real estate, marketable stocks or family businesses held as community property can avoid all capital gains tax upon sale after the death of the first spouse.*

The Alaska Community Property Trust

In our example, John and Mary do not have to move from Illinois to a community property state (and there enter into an agreement converting their marital property into community property) to achieve the result of *Example Variation #3*. Instead, they can, while remaining Illinois residents, establish an Alaska Community Property Trust and transfer the appreciated property to it while converting it to community property.

An Alaska Community Property Trust thus allows John and Mary to take advantage of Alaska's community property laws and have their Chicago apartment building characterized as community property.

How It Works

Under the Alaska Community Property Act, Alaska resident married couples may "opt in" to the community property regime, thereby converting some or all of their marital property to community property by written agreement. Under the Alaska Community Property Act, married couples who are not Alaska residents also may "opt in" to Alaska's community property regime by creating an Alaska Community Property Trust. Such couples may also specify which trust assets they want to become community property.

An Alaska Community Property Trust is a joint revocable living trust. However, the Alaska Community Property Act imposes certain conditions on it. It must have an Alaska trustee, which can be a bank or

trust company that exercises trust powers in Alaska or an individual whose true and permanent home is in Alaska. Also, the Alaska trustee must have at least certain specified powers or responsibilities regarding the trust, which do not have to be exclusive. Thus the trustmakers may serve as co-trustees to manage the property and assets held in the trust, and to take the income and, upon the death of the first spouse, have the trust assets "pour over" into the spouses' home state revocable living trusts.

Planning Tip: Assets transferred to the Alaska Community Property Trust will be titled in a way similar to: "John and Mary Smith, Trustees, and ABC Trust Company, Administrative Trustee, of the John and Mary Smith Alaska Community Property Trust dated _____________."

Planning Tip: Asset accounts can continue to be managed by the current advisor. An additional statement will need to be provided to the Alaska trustee.

Planning Tip: An Alaska bank or trust company's annual trustee fee for the minimum services and responsibilities required by the law is likely to be around $2500 per year. Fees are not fixed by law and so a trustee may charge less, especially if the client has another relationship with the bank or trust company. The client can determine if the benefits exceed the costs by comparing the trust creation and maintenance fees over the oldest client's life expectancy to the amount of capital gains tax that having the trust will avoid.

What to Look for When Evaluating Clients for this Strategy

Clients who are good prospects for establishing an Alaska Community Property Trust are married couples who are not community property state residents and who have one or more of these characteristics:

* They are in a long-term, stable marriage;
* They own (or one of them owns) highly appreciated property, stocks, real estate or business interests;
* Their financial portfolio is over-weighted in one or two stocks that they refuse to sell because of exposure to capital gains tax;
* They have rental real estate that the likely survivor does not want to manage;
* They are older or at least one has a reduced life expectancy.

Couples Less Likely to Benefit from Using this Strategy

Clients who are not good prospects for establishing an Alaska Community Property Trust are those with one or more of these characteristics:

* They have a recent marriage, especially one where property is kept separate;
* They have an unstable marriage;
* They have limited low basis property;
* They are in a second (or subsequent) marriage with prior-marriage children where property is kept separate.

Planning Tip: *Advisors in community property states should also be aware of this strategy for their clients who have relocated to a non-community property state.*

Alaska Community Property Trusts Benefit Clients *and* Advisors

Clients

The Alaska Community Property Trust is value-added planning for your clients and is only a part of a more comprehensive plan. It can provide substantial tax savings for the right clients and particularly benefits the surviving spouse more so than the children. It can empower a surviving spouse to diversify their portfolio by removing the capital gains tax exposure. For example, a surviving spouse who has not been involved in the management of rental properties can sell them without paying any capital gains tax.

Advisors

The financial advisor can continue to manage accounts while the property is in the Alaska Community Property Trust and increase capital under management when non-managed property is sold following the death of the first spouse. The advisor who begins to actively promote these trusts has an opportunity to distinguish himself or herself in the community.

Educating the Client and Advisors

The Alaska Community Property Trust is not a well-known strategy and is underutilized by many estate planning lawyers and CPAs. It is often confused with the Alaska Domestic Asset Protection Trust, which is completely different.

Here are some suggestions to help you get started:
* Identify clients with appreciated property.
* Calculate their current capital gains tax exposure, including recapture of depreciation.
* Calculate their capital gains tax exposure if the surviving spouse sells and receives a “step up” in basis on half of the property.
* Demonstrate the real tax savings potential to clients who would benefit greatly from using the technique.
* Estimate the costs, including legal and trustee fees, over the life

expectancy of the spouse who is expected to die first.
* Compare those costs to the estimated tax savings at the time of sale (and don't forget to factor in anticipated asset appreciation to the first death).
* Team with a WealthCounsel attorney who is familiar with drafting Alaska Community Property Trusts, and who can discuss this strategy with clients and other advisors as needed.

Planning Tip: The Alaska Community Property Trust works well with assets that have been placed in a Limited Liability Company or Family Limited Partnership. (The Alaska Community Property Trust will simply hold a membership interest in the LLC or limited partner interest in the FLP.) It also can work well with buy/sell agreements for family businesses.

Conclusion

The Alaska Community Property Trust offers an exceptional opportunity for the advisory team to collaborate to provide powerful tax savings for their clients. In addition, when an asset is sold without having to pay capital gains tax, the client will have more capital available for additional planning, such as dynasty trusts, and money management for the investment advisor. Therefore, Alaska Community Property Trusts offer a true win-win for clients and the advisors who recommend this strategy.

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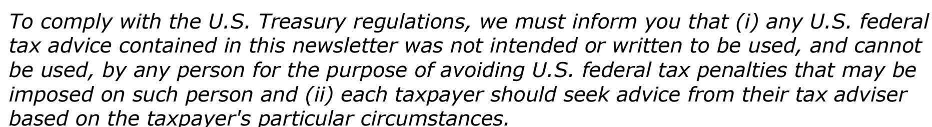
[1] The Alaska Community Property Trust is a completely different vehicle than the Alaska Domestic Asset Protection Trust.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