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Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2739

Date:29-Jul-19

Subject: Jamie M. Delman, David G. Shaftel & Jonathan G. Blattmachr on *Phillips v. Bremner-Phillips*, An Important Development Relating to Alaska Community Property Trusts - Will Intent and Purpose Prevail Over Drafting Ambiguity?

"The first Alaska Supreme Court case involving Alaska's Optional Community Property Act will not involve taxes. Rather, it is a property division issue in a divorce proceeding. This commentary discusses this pending divorce case and its misunderstanding of the tax purpose behind the enactment of Alaska's community property system."

Jamie M. Delman, David G. Shaftel and **Jonathan G. Blattmachr** provide members with important and timely commentary on *Phillips v. Bremner-Phillips*.

Jamie M. Delman is an attorney at **Shaftel Delman Kaufman** in Anchorage and is admitted in Alaska and New York. His practice focuses on estate planning, probate, and trust administration.

David G. Shaftel is an attorney at **Shaftel Delman Kaufman** in Anchorage and is admitted in Alaska, Washington, and California. He has been very involved in the drafting of Alaska's trust and estate statutes. He is a member of ACTEC and his practice involves estate planning and estate and trust administration.

Jonathan G. Blattmachr is a retired member of **Milbank** (formerly Milbank, Tweed, Hadley & McCloy LLC) and of the Alaska, California and New York bars. He is **Director of Estate Planning of Peak Trust Company,** the Editor-in-Chief of Interactive Legal and a Director of Pioneer Wealth Partners, LLC. He is also the author or co-author of nine books and over 500 articles. He was the principal drafter of the Alaska Trust Act and the Alaska Community Property Act.

Here is their commentary:

EXECUTIVE SUMMARY:

Alaska community property trusts provide an important tax benefit for married couples residing both inside of Alaska and outside of Alaska. As with other forms of community property, Alaska Community Property will enjoy the "double step up in basis" at the death of the spouse first to die. Pending before the Alaska Supreme Court is a case in which the trial court held that, unless appreciation and income are expressly declared in a community property trust to be community property, they will remain individual property and therefore not be subject to division at divorce. If the trial court holding is upheld and if it applies for tax purposes, then the basis adjustment will not apply to appreciation and income held by trusts which are silent with respect to this subject. Pending the interpretation of the statute by the Alaska Supreme Court, or a future legislative cure, planners should recommend amendments to Alaska community property trusts which expressly cure this issue.

FACTS:

John and Barbara Phillips were married in 1991. In 2007, as part of their estate planning, John and Barbara formed a joint revocable trust. When the trust was formed, John initially transferred three parcels of real property to the trust, two of which that he had acquired before marriage and one of which he had acquired during the marriage. After the trust was formed, an additional parcel of real property and a bank account were transferred to the trust. No property was ever listed as separate property on the trust's appropriate schedule. Indeed, the word "None" appeared on each separate property schedule. The trust is silent on whether appreciation and income from community property owned by the trust is to be community property.

John filed for divorce in 2015. The spouses agreed that the parcels were community property and therefore subject to division by the court.[i] However, John argued that the appreciation and income from the parcels remained his separate property and therefore not subject to division absent the need for a "balancing of the equities between the parties."[ii] John based his argument on Alaska Statute 34.77.030(h) of Alaska's Community Property Act, which provides:

> (h) Appreciation and income of property transferred to a community property trust is community property if declared in the trust to be community property.

The controversy is the meaning of the statute, especially in view of the intent and purpose of the enactment of the Alaska Community Property Act. The superior court ruled in favor of John, holding that appreciation of, and income from, the parcels were not community property, and therefore were not subject to division between the spouses. Barbara has appealed to the Alaska Supreme Court.

COMMENT:

WHY DO ESTATE PLANNERS CARE ABOUT THIS DIVORCE CASE?

Community Property

Alaska's optional community property system provides significant planning opportunities for residents of Alaska and also for residents of separate property states. Community property has historically received more advantageous tax treatment than other forms of property owned by married persons. Prior to the allowance of joint income tax returns in 1948, each spouse in a community property state was taxed on one-half of community property income, reducing the effect of the progressive income tax rates. *See Poe v. Seaborn*, 282 U.S. 101 (1930). Similarly, only one-half of assets held as community property would be included in the estate of the first spouse to die. This aspect of community property was very important before the estate tax marital deduction became law. With respect to intra-spousal gifting, community property ownership was beneficial before the unlimited gift tax marital deduction because only one-half of a gift of a community property asset to one's spouse would be subject to gift tax. And, before gift-splitting was available, community property ownership was beneficial because gifts to someone other than one of the spouses were treated as made one-half by each spouse. Those differences were so favorable that several states converted or considered converting their basic ownership regime for married couples resident in their states to community property. See, generally, Blattmachr, Zaritsky & Ascher, "Tax Planning With Consensual Community Property: Alaska's New Community Property Law," 33 Real Prop. Prob. & Tr. J. 615 (1999).

The tax differences described above between community property and non-community property of married persons were largely extinguished in and after 1948 by the allowance of joint income tax returns for married couples, gift-splitting and a 50 percent marital deduction.

However, Sec. 1014(b)(6) of the Internal Revenue Code of 1986, as amended, continues to provide a very favorable rule for a married couple owning community property. That section provides that the income tax basis of both halves of an item of community property will be increased (or decreased) to their value on the date of the death of one of the co-owners or, if elected, the alternate valuation date. In other words, both halves of the community property receive the income tax-free adjustment of income tax basis when the first spouse dies. Therefore, when one spouse dies, if the married couple owned all of their assets as community property, all of the community property receives a change in basis. By contrast, if non-community property were owned by the same couple as equal tenants-in-common (probably the closest form of ownership to community property), only the half owned by the first spouse to die would have its basis adjusted at the first spouse's death.

This unusual tax benefit for community property has historical roots. In the years following World War II, the husband typically owned the family property in his name and the husband typically died first. Therefore, in separate property states, when the first spouse died (typically the husband), all of the family property would receive an adjustment of basis to fair market value and the surviving widow could sell the property without any tax. However, with respect to the community property states (prior to Alaska enacting a community property system, there were nine community property states) the IRS argued that when the husband died only one half of the assets qualified for an adjustment of basis. This was because, the IRS argued, the property was community property and the deceased husband only owned a one-half interest in the property. Pursuant to subsection Section 1014(b)(1), only the decedent's half of the community property qualified for an adjustment of basis.

To place themselves in the same position as separate property states, the community property states went to Congress and successfully lobbied for subsection (b)(6). The result was that when the husband died both halves of the community property received an adjustment of basis, and the result was the same as if the husband and wife had lived in a separate property state.

Interestingly, lifestyle patterns have changed. In the twenty-first century, it is more likely that the husband and wife will own the majority of their property jointly rather than the husband owning all of it in his name. Therefore, in community property states, as explained above, when the first spouse dies all of the property receives an adjustment of basis. However, in the 40 separate property states and the District of Columbia, only one half of the assets receive an adjustment of basis. The tide has turned. For income tax purposes, it is now more beneficial to live in a community property state when the first spouse dies.

Alaska Community Property Act

The Alaska Community Property Act permits married Alaskans to elect for all or part of their assets to constitute community property under Alaska law by contract (known as a community property agreement) or by transferring property to an Alaska Community Property Trust and declaring it to be community property. Also, by transferring assets to an Alaska Community Property Trust, a married person or persons residing in other states may convert all or part of his, her or their assets to community property under Alaska law. If a couple from a community property state (e.g., California) moves to a non-community property one (e.g., Florida), it is not at all certain that their California community property will be entitled to the treatment provided under subsection Section 1014(b)(6) because it may no longer be community property under the community property laws of a state. Hence, the couple may consider transferring their assets to an Alaska Community Property Trust and declaring it to be community property under Alaska law.

Alaska community property is similar to community property in Wisconsin – both being derived from the Uniform Marital Property Act. Because community property under Alaska law, like community property under Wisconsin law (or that of any other state), is community property under the "community property laws of [a] State," Alaska community property should logically receive the same basis treatment under Code Sec. 1014(b)(6) as does community property under the law of any other state. See Rev. Rul. 87-13, (Wisconsin marital property is community property under Code Sec. 1014(b)(6)).

Indeed, one of the principal purposes of the Alaska Community Property Act was to allow married couples to enjoy the benefits of Code Sec. 1014(b)(6) by having their property be community property under Alaska

law by contract or by transferring the property to an Alaska Community Property Trust and declaring it to be community property. *See* Ex. 1, Minutes, House Judiciary Committee hearing on HB 99 at Tape 97-61, Side A, as follows: Representative Ryan, Nos. 0221, 0316, 0054, 0434, 0487; Jonathan Blattmachr, Nos. 0610, 0901, 1202, 1856, 1412, 1515; Representative Croft, Nos. 1515, 2046; Richard Thwaites, Nos. 1531, 2070, 0730; Richard Hompesch, No. 1707; Linda Hulbert, No. 1817; George Goerig, No. 0767.

This tax benefit is sometimes referred to as the "double step up in basis" when the first spouse dies. See, generally, Hartnett, "Basics of Estate Planning: Community Property and Separate Property," American Academy of Estate Planning Attorneys (Mar 1, 2017) available at:

https://www.aaepa.com/2017/03/basics-estate-planning-community-property-separate-property/.

Several thorough articles have been written describing Alaska's elective community property system and how it can be used by non-residents. M. Read Moore, "Coming Soon to Your State: Community Property," The Thirty-Fourth Annual Philip E. Heckerling Institute on Estate Planning (2000). Shaftel and Greer, "Obtaining a Full Stepped-Up Basis Under Alaska's New Community Property System," Estate Planning, March/April 1999, Vol. 26, No. 3. Blattmachr, Zaritsky and Ascher, "Tax Planning With Consensual Community Property: Alaska's New Community Property Law," 33 Real Property, Probate and Trust Journal 615 (1999). These articles include a conflict of laws analysis of the use of Alaska's elective community property system by nonresidents.

THE SUPERIOR COURT'S HOLDING

In *Phillips*, the superior court interpreted Alaska Statute 34.77.030(h) to require an affirmative action on the part of the parties drafting the trust to declare that "appreciation and income of the property" are community property. The meaning of the statute is ambiguous. Specifically, the phrase "if declared in the trust to be community property" may modify either the phrase "property transferred to a community property trust" or the phrase "appreciation and income of the property transferred." Both constructions are reasonable.

Under the first construction, the statute means that if property is contributed to the trust and is declared to be community property, then income and appreciation on such property are also to be community property. Under the second construction, income and appreciation are community property only if the trust specifically so provides.

But even if the Alaska Supreme Court constructs the text of AS 34.77.030(h) in the same manner as the Superior Court, it should consider that language in the context of the Alaska Community Property Act as a whole. In *Homer Elec. Ass'n v. Towsley*, 841 P. 2d 1042, 1044 (Alaska 1992), the Alaska Supreme Court found that "even where the statutory language considered alone seems to leave room for only one meaning, an appellate court nonetheless may consult legislative history and the rules of statutory construction, realizing that sometimes language that seems clear in the abstract takes on a different meaning when viewed in context." The *Homer Electric* court also observed that "a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant." *Id.*

Against the backdrop of *Homer Electric*, overwhelming evidence supports the conclusion that appreciation on community property should be characterized as community property even in a case like *Phillips*, where the trust instrument is silent on this subject. This evidence includes the initial purpose for the enactment of Alaska's optional community property system, the intent of the drafter of Alaska's community property system (Jonathan Blattmachr), the legislative history, the intent of the drafters of the Uniform Marital Property Act upon which Alaska's community property system is based, the intent of the clients' estate planning attorney, and the intent of the clients when they opted into Alaska's community property system.

In addition, if the intent of the legislature was to make a default rule that appreciation and income in community property trust were individual property, it is surprising that the Act does not address a number of fundamental consequences flowing from such a rule, specifically: allocation, valuation, and measurement.

Allocation

The *Phillips* court allocated all of the appreciation to John's separate property. But determining that appreciation is separate property should not be synonymous with determining that the appreciation is allocable John alone. Immediately after the contribution to the trust (and before any

appreciation would have occurred), John and Barbara each had a present one-half interest in the parcels under Alaska Statute 34.77.030(c). Even if the subsequent appreciation that occurred is, under *Phillips*, not community property, it would seem to reason that the appreciation that occurred on Barbara's "present one-half interest" in the parcels would be Barbara's separate property.

Valuation

If the default rule treats appreciation as separate property, then valuation upon contribution to a trust would be of critical importance. Otherwise, the parties would have no way at a later date of determining which portion of the trust was attributable to appreciation. However, the statute provides no requirement that property be valued when contributed to a community property trust.

Measurement

The Act provides no guidance about how to measure appreciation that occurs in a trust. With good valuation information, measuring appreciation when all trust assets increase in value is relatively straightforward. However, if some items of community property lose value and some items of community property gain value, the inquiry is much less apparent. For instance, imagine that wife contributes Blackacre and Whiteacre to a community property trust when they are both valued at $400,000. A few years later, when wife and husband are divorcing, Blackacre is worth $600,000 and Whiteacre is worth $200,000. While Blackacre has certainly appreciated, the community property as a whole has not changed in value. The statute provides no guidance as to whether there has been any appreciation of community property in such an instance.

WHAT TO DO IN THE MEANTIME

Planners and clients should review their existing Alaska community property trusts. Most of these trusts are joint revocable trusts. All community property trusts are revocable. If the trusts are silent with respect to appreciation and income then they should be amended in order to make it clear that they achieve the adjustment of basis purpose for opting into Alaska's community property system.

Conclusion

The superior court held that, under Alaska Statute 34.77.030(h), appreciation and income of property transferred to an Alaska community property is not community property unless the trust instrument specifically provides that it is. This interpretation directly conflicts with one of the main purposes of the Alaska Community Property Act: basis adjustment to fair market value at the death of the first spouse to die. *Homer Electric* directs that an appellate court, in interpreting a provision of a statute, may consider the provision in the context of the entire statute and its legislative history. A review of this context and history clearly indicate that the superior court's interpretation is inconsistent with the purpose of the Alaska Community Property Act. Further, the superior court's holding creates questions of allocation, valuation, and measurement. It is hoped that this will be reversed by the Alaska Supreme Court and the Alaska legislature will clarify the statute.

Alaska Community Property can provide a significant benefit for Alaska couples, using an Alaska Community Property Agreement or Alaska Community Property Trust, as well as those from other states using such a trust. In fact, with the present emphasis on income tax planning in connection with estate planning, ensuring a maximum step up in basis is now key. See, generally, Blattmachr & Rivlin, "Searching for Basis in Estate Planning: Less Tax for Heirs," 41 Estate Planning 3 (Aug. 2014).

The Alaska community property trust offers practitioners everywhere the option of establishing a form of co-ownership that will equalize the clients' estates (thereby maximizing the use of the lower estate tax rate brackets and exemptions), avoid supervision of the estate administration by probate courts, and possibly effect a substantial increase in the adjusted basis of the surviving spouse in his or her own share of assets previously owned jointly by the couple. The Alaska Community Property Trust is an arrangement worthy of serious consideration by any client who has a stable marriage, and who is comfortable with an equal division of all or certain assets between the spouses.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITE AS:

LISI Estate Planning Newsletter #2739 (July 29, 2019), at http://www.leimbergservices.com

CITATIONS:

Alaska Statute 25.24.160(e); Alaska Statute 25.24.160(a)(4); Alaska Statute 34.77.030(h); *Phillips v. Bremner-Phillips* (case no. 3AN-15-07027 CI); *Poe v. Seaborn*, 282 U.S. 101 (1930); Blattmachr, Zaritsky & Ascher, "Tax Planning With Consensual Community Property: Alaska's New Community Property Law," 33 Real Prop. Prob. & Tr. J. 615 Real Property, Probate and Trust Journal Winter, 1999; Section 1014(b)(6) of the Internal Revenue Code of 1986, as amended; Section 1014(b)(1) of the Internal Revenue Code of 1986, as amended; Rev. Rul. 87-13, 1987-1 C.B. 20; Uniform Marital Property Act; Ex. 1, Minutes, House Judiciary Committee hearing on HB 99 at Tape 97-61, Side A, as follows: Representative Ryan, Nos. 0221, 0316, 0054, 0434, 0487; Jonathan Blattmachr, Nos. 0610, 0901, 1202, 1856, 1412, 1515; Representative Croft, Nos. 1515, 2046;

Richard Thwaites, Nos. 1531, 2070, 0730; Richard Hompesch, No. 1707; Linda Hulbert, No. 1817; George Goerig, No. 0767; Hartnett, “Basics of Estate Planning: Community Property and Separate Property,” American Academy of Estate Planning Attorneys (Mar 1, 2017) available at https://www.aaepa.com/2017/03/basics-estate-planning-community-property-separate-property/; M. Read Moore, “Coming Soon to Your State: Community Property,” The Thirty-Fourth Annual Philip E. Heckerling Institute on Estate Planning (2000); Shaftel and Greer, “Obtaining a Full Stepped-Up Basis Under Alaska’s New Community Property System,” Estate Planning, March/April 1999, Vol. 26, No. 3.; *Homer Elec. Ass’n v. Towsley*, 841 P. 2d 1042, 1044 (Alaska 1992); Alaska Statute 34.77.030(c); Blattmachr & Rivlin, “Searching for Basis in Estate Planning: Less Tax for Heirs,” 41 Estate Planning 3 (Aug. 2014).

CITES:

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[i] Alaska Statute 25.24.160(e).

[ii] Alaska Statute 25.24.160(a)(4).