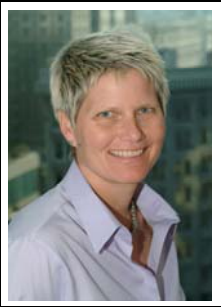


Why Two Trusts May Not Be Better Than One

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February 2010



New Concepts in Estate Planning for Same Sex Married Couples and Other Legally Recognized Couples

Historically, same sex couples have been treated as unmarried persons for estate planning purposes. In states like California that have community property laws firmly in place and which accord such rights and responsibilities to same sex married couples and registered domestic partners, however, this treatment is no longer appropriate. By simply ignoring the concept of legally shared property and the potential tax benefits of community property ownership at death when drafting estate plans, practitioners open themselves up to potential liability for failing to zealously advocate for their clients. Moreover, such treatment does not fully recognize the clients' legal status, even if the source of those rights is state, rather than federal, law, and even if there are still unresolved issues with how these legally recognized couples may be treated by the IRS.

For same sex married couples ("SSMC" - which, for purposes of this article will also include California Registered Domestic Partners unless stated otherwise), the source of the funds and/or assets is vitally important to the determination of community and separate property status, and transmutation of either type of property may still subject SSMC to potential gift tax implications. Community property cases in California, which date back to the early 1930s, clearly hold that the classification of property and the income from that property relate to the nature of the property as determined by state law. Although marriage is a venue for the state to confer community property rights upon a couple, it is clear that federally recognized marriage is not determinative of a couple's access to community property rights in California. For California residents who, according to state law, have true community property, earnings, and income acquired after the date of union, each party owns one-half of the asset no matter which partner was the earner.

Based on the holding in the *In Re Marriage* case (the 2008 California marriage case) and the subsequent enactment of SB 54, marriages and other legal unions performed elsewhere are recognized in the State of California, so that couples in this situation who are living in California are also subject to the rights and responsibilities of the California community

property regime. It is also important for practitioners to be aware that the laws effecting the determination of community property rights extend to the earlier of the date of registration with the state or the date of marriage whether in the state of California or another jurisdiction where such unions were performed validly. (SB54, 2009).

A resulting issue that becomes more relevant is the classification of additional income derived from assets that are clearly community property. For example, if, during marriage, Partner A earns a one million dollar bonus and pays the income taxes on these earnings when earned, the subsequent funds are community property and all income derived from any investment of those funds thereafter is presumably community income. As such, that income should be allocated on Schedule B of the income tax returns. This approach was confirmed in a recently decided case in Alameda County Probate Court in which the survivor of a same sex marriage petitioned the court to confirm the survivor's one-half ownership in a bonus paid out after death to his decedent spouse. The court affirmed that one-half of the bonus was, in fact, the survivor's under California state community property law. As such, the survivor's one-half of the bonus will be removed in the estate tax return of the decedent because the decedent did not own it at the time of his death. Income taxes owed on the earnings will still be fully attributable to the decedent in this case with appropriate state taxes attributable to the one-half paid to the survivor.

Although the IRS has indicated that same sex unions will not be recognized for income tax purposes, there have been tax filings that have successfully challenged this holding. In fact, in one recent case, where a same sex married couple filed federal returns jointly and were owed monies as if their status as "married" was accepted, the IRS actually refunded the overpayment of taxes. The tax practitioner in that case fully disclosed that they were a same sex married couple and now is amending the past three years of returns as well. Obviously, because this is not a settled area of tax law, anyone considering this approach on behalf of their clients should be fully aware of the risks and standards involved.

When viewed within this framework, another important consideration for practitioners is whether the requirements that community property be equally managed and controlled by both owners can be satisfied with a single settlor trust.

Assuming that the parties pay income taxes on earnings, individually, when earned, and deposit such earnings into the earner's own trust account, then a single settlor trust would not necessarily satisfy this requirement because the non-settlor party may be precluded from exercising her or his right of management and control over what is clearly community property.

A single settlor trust with two trustees may be a solution because the surviving partner who is also the second trustee could elect to characterize property held in that trust as community property during the trust administration. The ease of electing community property during the administration of a trust is increased.

A better solution is to establish a joint trust in which property can be held as community property or separate property, just as is commonly done for opposite sex married couples. In this case, the earner may establish accounts in her or his trust with both parties as Trustee, and a joint trust does not necessarily transmute property if properly drafted. Moreover, a joint trust allows the survivor to take her or his separate property and her or his one-half the community property, which is the property the survivor already owns, at the first death and remain in control of those assets without forcing a transfer of the assets. Under state law, because the decedent does not own more than one-half of the community property, there is good reason and legal basis not to include those assets as taxable property in an estate tax return, if it is necessary to file a return. This becomes even more relevant when there is a disparity in earnings during the relationship and the accumulation of assets may appear to belong only to the earner, even though, under the community property regime, one-half of the earnings belong to the non-earner party. This will also be important when there have been significant community property assets added to what may started as separate property, such as where community earnings are used to reduce the outstanding mortgage for a house originally purchased by only one party, or when payments on life insurance policies have been made from community property earnings. In that case, the survivor may own one half the policy no matter who is the designated beneficiary. Furthermore, because IRAs are not governed by ERISA, arguably, DOMA does not trump, and annuities are regulated by the State Department of Insurance, which should allow SSMC to be treated as opposite married couples for beneficiary purposes.

Federal treatment of community property for SSMC may or may not be analogous to federally recognized couples, despite the fact that California will treat community property the same for all married couples. For instance if community property has the right of survivorship, could tax treatment be the same as joint tenancy property for SSMCs? Also the issue of DOMA arises – but presumably in the context of marriage and not so conclusively in the context of domestic partnership. The *In re Marriage* case and the subsequent vote on Prop 8 in California clearly demonstrates that domestic partnership and marriage are different legally. There are myriad other questions that present when advising SSMCs, such as the application of the double step up in basis for state purpose, but possibly not for federal purposes; the possibility of drafting with a marital exemption trust depending on the new tax laws; how to schedule property; proper titling; and educating a client, all of which can be time consuming and complicated.

Tax practitioners, for the most part, have determined that they will only prepare returns for a couple when they are married and/or registered as domestic partners, as the treatment of one affects the treatment of the other and, arguably, this is also true for estate planners absent mitigating circumstances. Certainly, in the absence of the unlimited marital deduction for same sex couples, which allows federally recognized married persons to transfer assets among themselves without tax consequences during their marriage, and which extends to most transfers at divorce as well, there are limitations to the position that an estate planner may want to take or incorporate on behalf of their clients. Savings clause and tax allocations in joint trusts can be written so that the survivor's share, even if ultimately determined to be includable in the estate of the decedent, will not be diminished by estate taxes paid, which potentially raises the underlying issues of the attorney client duty of loyalty when doing joint planning, as well as the standard of care for practitioners. A practitioner who will not help the clients jointly determine the characterization of property and subsequent treatment and ownership of assets at death, however, arguably opens her or himself up to potential liability if allocations of community property to third parties are effectuated and/or if planning opportunities are missed. Many practitioners have been wary of involving themselves in property characterizations or taking stances in their planning that are not fully clarified through law or code. The survivor who later learns that no attempt was made to minimize the estate of the decedent, or who was not properly informed of her or his ownership or legal claims to certain property under state law, however, will likely be the disgruntled client and have issues to raise about the standard of practice.

Estate planning for SSMC has become an area in which practitioners should be constantly analyzing possibilities that exist to advocate on behalf of clients because of existing contradictions in the law, unsettled areas that make legal sense but may not have yet been litigated or decided upon, and/or areas where the IRS has not yet issued controlling guidance. Full disclosure to clients as to the choices that they may evaluate and ultimately make is absolutely necessary and the challenge remains in educating a client about the nuances, the uncharted territories and the possible implications of their decisions without overwhelming them.