Community Property vs. Separate Property – Step-up in basis rules and tax planning strategies

September 23, 2019, by Hassan Sultan, CPA, CVA, MBA

SHARE:

Community property is generally defined as the property that is acquired during a marriage in a community property state. The basic idea is that the fruits of the labor of either spouse is the property of the 'spousal community' and is therefore shared equally. In community property states, the property acquired during a marriage is considered community property unless it was gifted, inherited, or acquired prior to marriage.

Nine states have community property, all but one are west of Mississippi. These states include Arizona, California, Idaho, Louisiana, New Mexicso, Nevada, Texas, Washington, and Wisconsin.

From an income tax perspective, community property has a significant tax advantage i.e. upon the death of the first spouse, the entire property (regardless of legal ownership) gets step-up in basis.

In separate property states, only the part of the property which was owned by the deceasing spouse gets step-up in basis.

Let's explore a scenario:

> *Peter and Jane jointly own a house in Virginia. They purchased the house for $1 million and the house's current market value is $2 million. Jane passes away in 2019 and Peter inherits the house. Peter will get step-up in basis on Jane's half of the house and not on his half of the house. His new basis will be $1.5 million. Now let's assume Peter and Jane live in Nevada, a community property state. In this case, Peter will get step-up in basis on the entire house. His new basis will be $2 million. Essentially, Peter can sell the house for up to $2 million, without paying any capital gains tax.*

What if you don't live in a community property state but want to take advantage of the step-up in basis that community property provides? You can convert separate property into community property by forming a community property trust. Currently, Alaska, South Dakota, and Tennessee allow for the formation of community property trusts to residents of other states. Essentially, a married couple in a separate property state can transfer assets into a community property trust in one of the above-mentioned states and convert separate property into community property.

This could be a great strategy for a couple where one spouse is in poor health and there is a strong chance that the community assets will be sold after the death of the first spouse.

You've heard our thoughts… We'd like to hear yours

Our blog exists to create a dialogue on issues that are important to individuals and businesses. While we enjoy sharing our ideas, we're especially interested in what you may have to say. If you have a question or a comment about this article, we hope you'll share it with us. Materials provided are meant for informational purposes only, and it is not to be construed as investment, tax, or legal advice. Please note that individual situations can vary.

HASSAN SULTAN, CPA, CVA, MBA

Shareholder , Reckenen, Inc.

Hassan Sultan has over 20 years of experience in the areas of taxation, business valuation, and non-profit financial management. His scope includes income tax preparation for individuals and businesses of all types, trusts, and outsourced CFO services to non-profit organizations. He also provides business valuation and litigation support. Hassan earned a bachelor's degree in management from the University of Florida and an MBA from Carnegie Mellon University.

Email

hsultan@reckenen.com

Call

571-989-1300

SHARE: