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A New Tool in the Planner’s Toolbox

Florida’s Community Property Trust Act - Explained

Joseph M. Percopo, Esq.

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Agenda

- History of Community Property
- Tax Law Basics
- Policy Behind Double Basis Step-Up
- Florida Community Property Trust Act
- Double Basis Step-up for FLCPT?
- Drafting Styles
- Federal Law Considerations
- State Law Considerations
- Practice Tips

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History of Community Property

Community Property vs. Separate Property

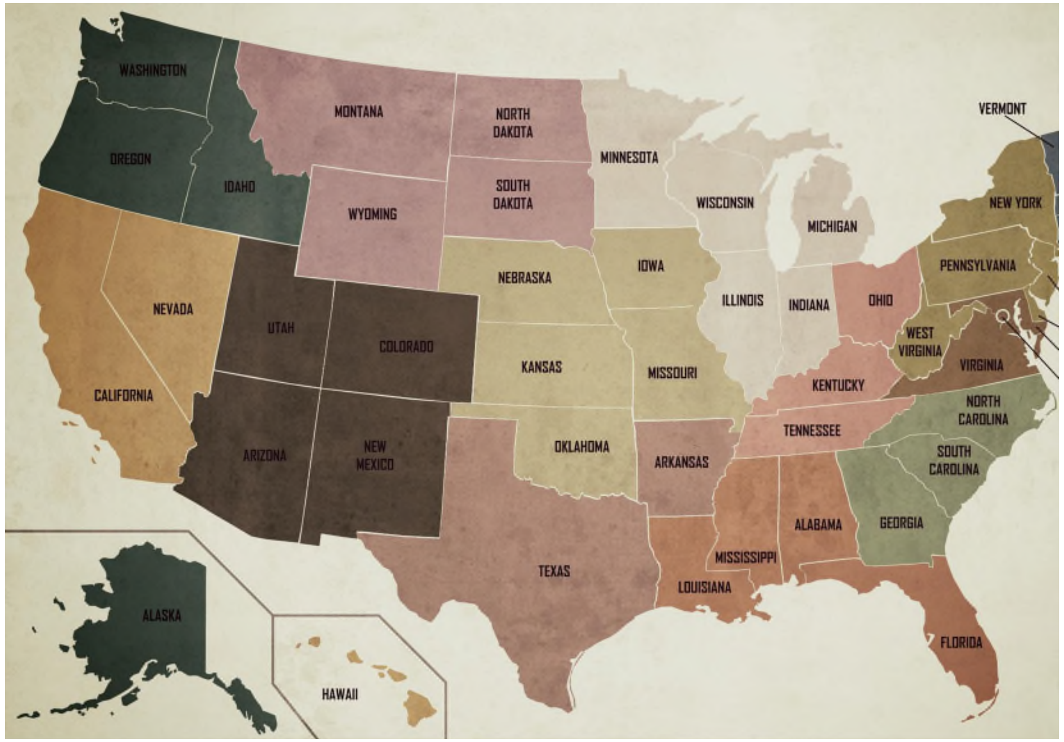
Community Property Overview

Community Property is derived from civil law traditions, specifically Spanish and French law, governing property rights within marriage.

Separate Property Overview

Separate Property is based on common law traditions, influenced by English law, and applies to individual ownership in states like Florida.

Community Property Jurisdictions



U.S. Community Property States

The states (8) that follow community property laws include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

Wisconsin's Marital Property

Wisconsin is technically a marital property state but is recognized as a community property jurisdiction by the IRS.

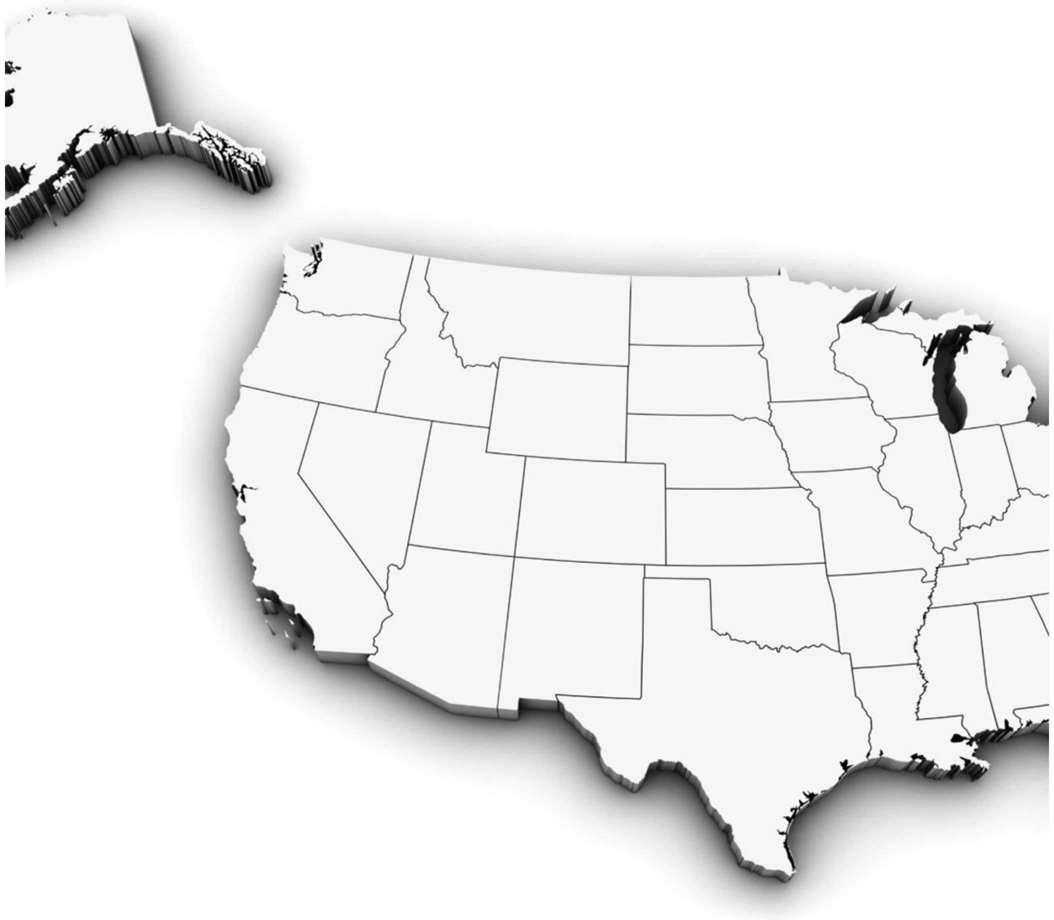
Territories with CP Laws

Puerto Rico and Guam are territories that also follow community property laws.

International Community Property

Many other countries around the world have their own community property laws, which can vary significantly.

Community Property Jurisdictions



Established CP Trust States

States like:

Alaska (1998),
Tennessee (2010),
South Dakota (2016),
Kentucky (2020), and
Florida (2021)

have established community property trust laws.

Ohio's Legislative Efforts

Ohio is currently working on legislation to join the list of community property trust states.

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Tax Law Basics

General Rules

Taxable Event from Sale

The sale of an asset triggers a taxable event, which can result in gains or losses based on the consideration received and tax basis in the asset sold.

Understanding Gain

A gain occurs when the value received exceeds the taxpayer's basis in the asset sold.

Basis of an Asset

A taxpayer’s basis in an asset typically equals the consideration given at the time of purchase.

Gifted and Inherited Assets

Gifted assets carryover the donor's basis, while inherited assets receive an adjusted basis based on fair market value.

Tax Basis Adjustment at Death

Sole Ownership Adjustment

In sole ownership, the tax basis is adjusted to 100% of the fair market value (FMV) at death.

Tenants in Common

For tenants in common, the FMV basis adjustment depends on the percentage interest included in the decedent's estate (as determined by state law).

Joint Tenants – Other than Spouses

Joint tenants with rights of survivorship (JTROS), other than spouses, have 100% inclusion in the decedent's gross estate, reduced by amounts contributed by the other co-owners unless acquired by gift or inheritance. Tax Basis = FMV of % ultimately included in gross estate.

JTROS (Spouses) and Tenants by the Entirety (TBE)

JTROS & TBE provides a 50% FMV basis adjustment (without discounts)

Community Property

Community property allows for a 100% FMV basis adjustment if at least 50% of the asset is included in the estate.

Back to (*Tax Law*) Basics

NO. 3 – TAX BASIS

EXHIBIT "A"
COMMUNITY PROPERTY INCOME TAX ILLUSTRATION

Assets

	Acquisition cost (Basis)	Fair Market Value (FMV)	Gain from Sale During Life
Stock	$300,000	$700,000	$400,000
Real Property*	$500,000	$1,200,000	$700,000
Total:	$800,000	$1,900,000	$1,100,000
Long Term Capital Gains Tax (LTCG)**	15%	$165,000	(Tax Owed)

Assets Owned: **H's Death Gross Estate Inclusion**	**100% Husband ("H")**	**100% Wife ("W")**	**H&W Tenants by the Entirety**	**H&W Community Property**
Stock	$700,000	$0	$350,000	$700,000
Real Property	$1,200,000	$0	$600,000	$1,200,000

W's New Asset Basis				
H's FMV Stock	$700,000	$0	$350,000	$700,000
W's Stock Basis	$0	$300,000	$150,000	$0
Total:	$700,000	$300,000	$500,000	$700,000
H's FMV Real Property	$1,200,000	$0	$600,000	$1,200,000
W's Real Property Basis	$0	$500,000	$250,000	$0
Total:	$1,200,000	$500,000	$850,000	$1,200,000
W's Stock Basis	$700,000	$300,000	$500,000	$700,000
W's Real Property Basis	$1,200,000	$500,000	$850,000	$1,200,000
Total:	$1,900,000	$800,000	$1,350,000	$1,900,000
W's Sale as Assets				
Total FMV	$1,900,000	$1,900,000	$1,900,000	$1,900,000
Total Basis	$1,900,000	$800,000	$1,350,000	$1,900,000
Gain:	$0	$1,100,000	$550,000	$0
LTCG 20% tax	**$0**	**$165,000**	**$82,500**	**$0**
W's Tax Savings	$165,000	$0	$82,500	$165,000

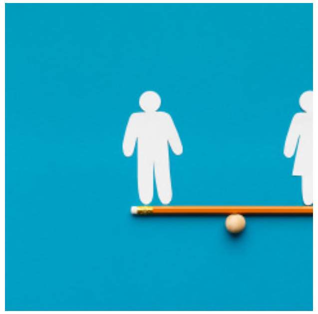
* Assumes no valuation discounts and
no elgibility for primary residence sale gain exclusion under IRC §121
**Calculated without application §1411 (3.8% net investment income tax)

Policy Behind Double Basis Step-Up

Historical Review

Enactment of Estate Tax

The US Estate Tax was enacted in 1916 during World War I.



Husbands as Asset Holders

Historically, husbands earned and owned most household assets.

Tax Treatment Disparity

The tax basis law at the time led to disparate treatment between community property and common law regarding basis step-up.

Common law – surviving spouse would get a 100% basis step-up

CP – surviving spouse would only receive a 50% basis step-up

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Modern Situation

IRC §1014(b)(6) Enactment

IRC §1014(b)(6), enacted in the 1940s, was intended to equalize tax treatment between community-property and common-law states.

Modern Asset Ownership

Both spouses earn and own property.

Tax Treatment Disparity (Flipped)

- The tax basis law originally designed to equalize CP treatment has turned into a tax law benefit over common law jurisdictions regarding basis step-up.

    Common law – surviving spouse would get a 50% basis step-up

    CP – surviving spouse would only receive a 100% basis step-up.

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Florida Community Property Trust Act

Enactment & Creation

Enactment Date

The Florida Community Property Trust Act was enacted on July 1, 2021, establishing a new framework for trusts and tool for planners.

Creation Requirements

To create a FLCPT, it must:

1. Be Created on or after 7/1/21
2. Be Expressly declared to be a FLCPT
3. Have at least one "Qualified Trustee"
   - Person located in FL or Company authorized to act as FL Trustee
4. Be Signed by both spouses (with testamentary formalities)
5. Contain <u>specific language</u> in capital letters near the beginning of the FLCPT
   - Disclosure which warns about the FLCPT impact to rights pertaining to creditors, divorce, and death

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Application

FLCPT Agreement Terms

The FLCPT agreement outlines rights, obligations, and management specifics, ensuring compliance with legal standards.

Qualified Beneficiaries

Only spouses are considered 'Qualified beneficiaries' during their lifetime, with no requirement to share information or accountings with others.

Community Property Trust

Assets in FLCPT are classified as community property,

FL Residency Not Required

FLCPT may be created regardless of the residency of the settlor spouses. *(Qualified Trustee keeps a Florida nexus.)*

FL Homestead

FL homestead property retains status as homestead.

Preexisting CP

CP transferred to a FLCPT will retain its character, even if later transferred back out

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Limitations

Death

Upon the death of the first spouse:

- The surviving spouse can amend the disposition of the surviving spouse share of the trust even if the FLCPT is “irrevocable.”
- The trustee selects the survivors 50% share, and the balance remaining constitutes the decedent’s and subject to the decedent’s testamentary provisions.

Divorce

- Assets are divided equally upon divorce, regardless of individual contributions (FL equitable division laws do not apply)
- Does not adversely affect child support obligations

Creditors

Half of the assets are vulnerable to individual creditors of each spouse, excluding homestead properties.

Enforceability Issues

- Agreements may be unenforceable if (1) unconscionable, (2) not executed voluntarily, (3) fraud or duress, or (4) lack of fair disclosure.

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Double Basis Step-up for FLCPT?

Support

IRC §1014(b)(6)

- ✓ Express language “under the community property laws of any State.”

Key Court Cases

- ✓ Willging (purpose of IRC §1014(b)(6) was to equalize treatment of CP and Common Law States)
- ✓ Westerdahl (Determined Swedish law was equivalent to CP laws consistent with US CP States)
- ✓ Angerhofer (Determined spouses did not opt into German CP law, therefore not CP in the US)
- ✓ Quintana (Found property acquired while working in Florida but domiciled in Cuba (PT jurisdiction) was CP and retained character even after domicile was changed to Florida)
- ✓ McCollum (Court found property was CP for tax purposes where couple opted into CP under Oklahoma law which resulted in full basis adjustment)
- ✓ BOA v. Comm’r (Tax court predecessor found transmutation agreement effective to create CP under CA law for Federal estate tax)

Support (cont)

PLR 199917025

- ✓ Agreement between spouses to convert separate property to CP was enforceable under state law and therefore treated as CP for tax purposes.

Rev. Rul. 77-359

- ✓ Washington spouses agreed to convert their separate property to CP. The IRS held that the conversion was effective for federal tax purposes

Rev. Rul. 66-283

- ✓ CA spouses transferred property to revocable joint trust which stated assets would remain CP. Upon death of husband, wife received double basis step-up.

Delaware Income Non-Grantor Trust Rulings

- ✓ IRS found CP assets transferred to trust in Non-CP jurisdiction retained CP status and received double basis step-up

Opposition

Comm'r v. Harmon (1944)

The Supreme Court ruled that Oklahoma's 'opt-in' community property statute was not effective for federal **income** tax purposes.

- Relied on case analyzing assignment of income rules as applicable to differing CP states
- Court did state "*once established, the community property status of Oklahoma spouses is at least equal to that of a man and wife in any community property State*"
- Rev. Rul. 77-359, IRS held that conversion to CP would be effective for gift tax purposes but not income tax purposes.

Florida Law Does Not Mirror other CP States

- However, CP jurisdictions address management, control, and disposition at death, which the Florida Community Property Trust Act expressly addresses (unlike TN and SD acts).
- Florida's divorce law – Equitable Distribution – is conceptual similar to CP.

IRS Publication 555, Community Property

- Acknowledges the community property trust concept but declines to address. Some argue this implies the IRS disagrees since it does address basis step-up on death in 9 other CP states.

Drafting Styles

Full Control FLCPT

Asset Continuation

Full Control FLCPT allows for the continuation of assets for the surviving spouse.

Deceased Spouse's Share

The deceased spouse’s share is added to the surviving spouse’s share.

Amendment Rights

The surviving spouse retains the ability to amend, modify, or revoke the FLCPT.

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Divided FLCPT

Trust Distribution Mechanisms

The deceased spouse’s share can pass to marital trust or credit shelter trust. May include use of disclaimer, formula funding, or Clayton Clause.

Survivor's Trust Authority

The surviving spouse retains only the right to amend or revoke the Survivor's Share of the FLCPT.

The marital trust or creditor shelter trust may not be amended.

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Pourover FLCPT

Survivor's Trust Distribution

Upon the first death, the survivor's share is allocated to their separate revocable trust.

Deceased Spouse's Trust

The deceased spouse’s share is transferred to their revocable trust.

Federal Law Considerations

Tax Basis

WILL THE IRS RESPECT THE FLCPT?

IRS Stance on FLCPT

The IRS has not directly addressed the FLCPT despite its existence since 1998, creating uncertainty in tax basis treatment.

Lack of Adverse Cases

There are no known reported adverse cases concerning FLCPT, indicating a lack of contested issues in practice.

Audit Reports

Practitioners have noted audits involving CP trusts, but the IRS has not contested the double step-up in basis.

Tax Basis

DEATHBED FUNDING - IRC §1014(e)

Estate Tax Treatment

Where a donor gifts appreciated assets, the donee dies within one year of the gift, and the property passes back to the donor, then the donor will maintain a carryover basis and not receive a basis adjustment to FMV on the donated assets).

- Result may be avoided by not having asset pass back to Donor spouse
- Martial Trust or Credit Shelter Trust?

FLCPT Application

If 50% of the asset is included in the deceased donee's gross estate, the donor **<u>may</u>** receive a basis adjustment for their 50% portion since that interest was retained and not gifted.

Tax Basis

PRO RATA vs. NON-PRO RATA DIVISION

Non-Pro Rata Division

Fla. Stat. §736.1507 allows for non-pro rata division of assets, impacting estate composition significantly.

Federal vs. State Tax Laws

Federal law dictates property taxation, while state law governs property rights relevant for taxation.

Aggregate vs. Item Theory

Item theory treats every asset as community property at death; aggregate theory requires only an even division of value.

- ❖ Florida statute appears more “aggregate” theory style

Will IRS respect division for FMV and basis purposes?

- ➢ PLR 8505006 held that under CA (item theory CP) that the estate owned an undivided ½ interest in each asset resulting in 50% of each asset being included in the estate.
- ➢ IRS Respects other post death actions - Elective Share and Alternate Valuation
- ➢ PLR 9422052 held executors could not use non-pro rata allocations to impact amount included in the gross estate for purposes of IRC 6166

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Tax Basis

FRACTIONAL OWNERSHIP

Valuation Adjustments

Valuation discounts and control premiums may apply to non-publicly traded assets included in a decedent's gross estate .

Not Optional

Valuation adjustments are not generally optional.

CP is Fractional Ownership

CP is by its very nature a fractional form of ownership and potentially subject to valuation adjustments.

Tax Basis

COMMUNITY PROPERTY WITH RIGHTS OF SURVIVORSHIP

Hybrid Ownership Model

Community property states have created a hybrid ownership form that includes rights of survivorship.

IRC §2040 Implications

IRC §2040 governs property with rights of survivorship and provides “the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified interest” without valuation adjustments.

IRS Guidance

IRS rulings provided undiscounted FMV basis adjustments for CP owned with “rights of survivorship.”

Fla. Stat. §689.15

Florida law permits the creation of survivorship through explicit designation among parties.

Tax Basis

PROPERTY LOCATED OUTSIDE OF FLORIDA

Will real or tangible personal property located in a non-CP state qualify for CP treatment using FLCPT?

Does the state have or recognize CP?

- There are 9 states that are classified as community property states & 16 with UDCPRDA (recognizes CP rights

Analysis:

1. CP State = very likely “Yes”
2. Recognizes CP = probably “Yes” if acquired directly by FLCPT (vs. separate acquisition and then transfer)
3. Does not Recognize CP = “Maybe”??
    1. Direct acquisition by spouses & then transfer to FLCPT = unlikely
    2. Acquisition by FLCPT = more likely
    3. Acquisition by Florida LLC owned 100% by FLCPT = likely

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LLC – Tax Status

Disregarded Entity Status

A CP LLC can be treated as a disregarded entity, meaning it doesn't require its own EIN or separate tax return.

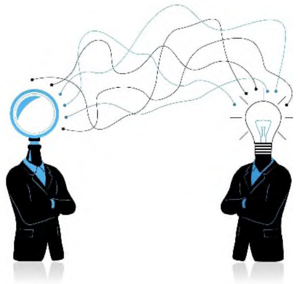
§1031 Exchanges

Utilizing FLCPT LLCs for §1031 exchanges to comply with the same taxpayer rules when involving new LLCs.

S Corporations

Eligibility Criteria

S Corporations must meet specific eligibility criteria to maintain their status and benefits, including ownership requirements.



Spousal Ownership

If spouses are the only grantors of the trust, the trust remains eligible as an owner as long as they stay married.

US Citizenship Requirement

Both spouses must maintain US citizenship to keep the trust's eligibility as an owner in an S Corporation.

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Gifts to U.S. Citizen Spouse

Unlimited Marital Deduction

Gifts to a US citizen spouse typically qualify for an unlimited marital deduction, meaning no gift tax applies.

QTIP Eligibility

Irrevocable gift must be QTIP eligible and election must be made on timely filed gift tax return.

Gifts to Non-Citizen Spouse

Taxable Gifts

Gifts exceeding $190K to a non-citizen spouse are subject to taxation under federal law.

Lifetime Exemption

Assets exceeding the federal lifetime exemption at death which pass to a non-citizen spouse will be subject to estate tax unless a QDOT is used.

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Loan Acceleration Clauses

Change of Ownership Trigger

Potential for a “change of ownership” loan trigger if original mortgage in the name of only 1 spouse is conveyed to FLCPT.

Garn-St Germain Act

As long as the beneficiaries consist of the grantor or grantor’s family, then lenders are prohibited from calling the loan due, with a transfer to a spouse or trust, whether the trust is revocable or irrevocable.

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State Law Considerations

Death of a Spouse

Asset Distribution Rules

The law mandates that each spouse must receive an aggregate of 50% of the FLCPT assets.

Non-Pro Rata Division

The act permits non-pro rata division, which, without guidance, can lead to unintended consequences, affecting asset selection and creditor exposure.

Survivor's Amendments

Survivors may amend up to 50% of their share following the death of the first spouse

- For how long after death?
- Can a spouse waive this?

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Florida Homestead

Devise Restrictions

- In Florida, you cannot devise a homestead if you have a spouse or minor children.
- A spouse way waive devise restriction, but the rights of minor children cannot be waived.
- If there is a minor child, likely result of invalid devise using the FLCPT
  - Possible workaround – allocating 100% of homestead to survivor’s share?

Irrevocable Trust

- An irrevocable Florida Homestead Trust can be used to avoid the devise restriction.
- FLCPT concerning because surviving spouse can amend up to 50% of the trust assets = ability to revest with homestead.

Transfer and Alienation Rules

- Transferring homestead property requires consent from both spouses, and both must sign the deed to avoid invalid transfers.

Tax Exemptions

- Continuation of Florida homestead tax exemption and limits annual tax increases.

Creditor Protection

- Maintains Constitutional creditor protection (.5 acre in city & up to 160 acres outside of city)
  - WARNING – no longer TBE, therefore if in excess of size limits homestead could be exposed.

Creditor Claims

No TBE Protection

CP is not tenants by the entirety and is lost when using FLCPT.

FLCPT Asset Exposure

50% of FLCPT assets are subject to claims by individual spouse's creditors (unlike TBE ownership).

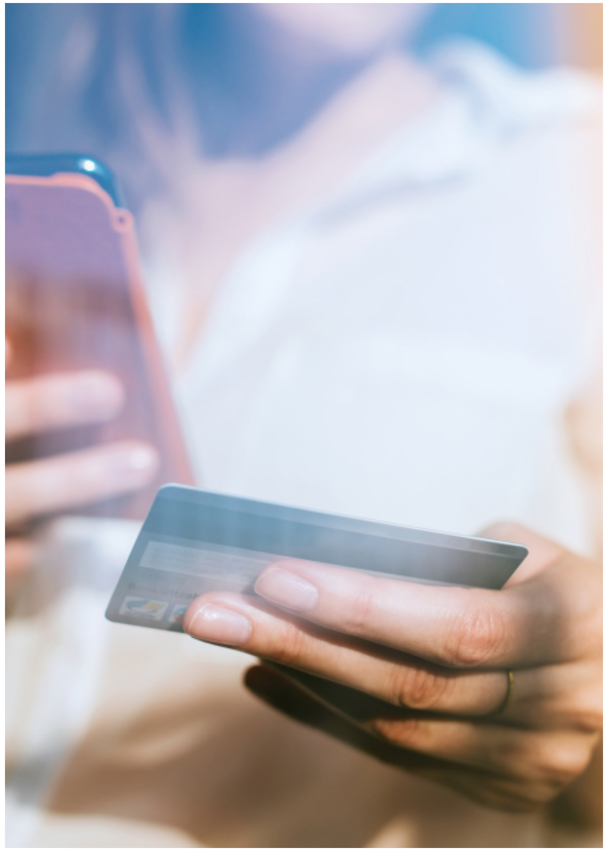
Exempt Assets

While Florida homestead is exempt from creditors, other statutory exemptions such as life insurance and annuities may not be.

Creditor Claim against FLCPT

Act appears to permit FLCPT to establish rules for which assets would be subject to creditors

- Non-pro rata division to control which assets are exposed
- What happens after claim paid?



LLC – Charing Order Protection

Charging Order as Creditor Remedy

The charging order is the exclusive remedy available against a multi-member LLC.

FLCPT – Single Member of Multi-Member LLC?

The issue of 100% ownership by FLCPT in LLCs has not been clearly addressed.

- FLCPT requires at least 2 people (spouses) and each has a "share"

Safe Ownership Approach

The safest strategy involves a person or trust owning part of the LLC, while the FLCPT owns the balance to minimize risk.

Nuptial Agreements

Division of Assets

Unclear if a nuptial agreement can circumvent the mandatory 50/50 aggregate division of the FLCPT assets upon divorce.

Execution and Amendments

The execution of the latter of FLCPT or nuptial agreements is likely to control, allowing for amendments with full asset disclosure.

Contrary to CP?

If FLCPT 50/50 divorce division is modified by nuptial, does that potential negate CP treatment?

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Enforceability

Single Attorney Representation

Having a single attorney represent both spouses is not sufficient grounds to nullify agreements or contracts.

Fraud and Duress

Fraud, duress, and insufficient disclosure of assets or liabilities can impact the enforceability of agreements.

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Amending & Restating

Definition of Community Property Trust

A community property trust is an express trust established under the guidelines of s. 736.1503 after July 1, 2021.

Legislation for Trust Modification

Proposed legislation allows for any trust to become a Family Limited Community Property Trust if amended after July 1, 2021.

Safest Approach Currently

- Do not amend and restate. Instead create a brand new FLCPT.
- Once legislation is passed, then amending and restating may become a safe option.

Documentary Stamp Tax for Real Property with Mortgages

Equal Ownership in Conveyance

When both spouses have equal ownership, transferring property to FLCPT does not trigger documentary stamp tax.

Technical Advice Letter

The FL DOR recently provided guidance on the issue.

Reassessment for Property Taxes

Equal Ownership

When both spouses have equal ownership, property tax reassessment is not triggered during conveyance.

Property Tax Reassessment

If triggered, property tax may be reset to FMV on portion of property thereby increasing the property taxes.

Practice Tips

Inform Clients

BENEFITS:

- Double Basis Step-up
- Allows for non-pro rata division after death (potential basis control)
- Allows for selection of assets potentially exposed to creditors
- Homestead creditor protection is maintained
- Simplicity (no need to equalize assets between spouses or multiple trusts)
- Still have QTIP option available and use of GST exemption
- Avoids need for tracing for community property brough into Florida
- Remains a valid Florida trust regardless of Federal tax treatment

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Inform Clients

CONCERNS:

- IRS not respecting FLCPT
  - Post death sale could result in more gain than anticipated or valuation discount may be applied at death that would not have been applicable as TBE
- Loss of TBE
- Death – survivor can pick assets and 50% amendable
- Divorce – 50/50 division of assets
- Creditors – 50% exposed to creditors (no TBE)
- Enforceability

UNFAVORABLE Situations for FLCPT

i. Second marriages

ii. A non-citizen spouse

iii. High risk professionals

iv. Spouses with complex pre or post nuptial agreements

v. Desire to have entire trust become irrevocable after death of first spouse

vi. Homestead in excess of size limitations (1/2 or 160 acres)

vii. Homestead with minor children (avoid)

viii. Assets that have FMV less than basis (potential for step-down in basis)

ix. Clients that want to amend and restate trusts created before 7/1/2021

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FAVORABLE Situations for FLCPT

i. Clients moving from community property states

ii. Clients already using or desiring joint trusts (except when clients desire 100% of the trust to be irrevocable upon the first spouse's death)

iii. Older clients

iv. No creditor concerns

v. Long term First marriages

vi. Highly appreciated assets owned by both or either spouse

vii. Highly appreciated homestead

viii. 1031 exchange situations for spouses desiring to use an LLC

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Drafting Considerations

FLCPT Style Options

- Consider Full Control, Divided, or Pourover styles for effective asset distribution in estate planning.

Asset Division Provisions

- Include provisions for asset division upon death, divorce, or creditor claims within the trust documents.
- Consider including language to limit period survivor can amend.

Florida Homestead

- Avoid FLCPT if minors.
- With spouse consider use of waivers depending on desired plan.

Rights of Survivorship

- Consider using rights of survivorship language regarding real property and business interests to ensure proper transfer

Rights of Survivorship

- Draft language for rights of survivorship regarding real property and business interests to ensure proper transfer.

Nuptials

- consider impact it may have on a preexisting agreement

Full Disclosure Requirement

- Ensure a provision is included for complete disclosure of assets and liabilities between spouses.

“If spouses ultimately decide to create a FLCPT, it is of the utmost importance that practitioners carefully consider the specific terms and provisions to be included in the trust due to the significant impact they may have with regard to tax basis, the death of a spouse, homestead, creditors, business entities, gifts to spouse, nuptial agreements, and enforceability issues.”

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Let's Connect!

Joseph M. Percopo, Esq.
(407) 841-1200 | JPercopo@deanmead.com