**Cross-Border Community Property Issues:**

**Been There, Bought That... Now Who Owns It?**

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## Fox Valley Estate Planning Council

## Butte Des Morts Country Club

## Appleton, Wisconsin

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1. **Basics of Wisconsin Marital Property Law**
   1. *Disclaimer*. There are nine (9) states in the United States that are considered community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Community property laws vary from state to state. Since the presenters are licensed to practice in Wisconsin, Minnesota, Florida and Arizona, this outline focuses on Wisconsin’s marital property law and Florida statutes. Community property issues related to a state other than Wisconsin (e.g., Arizona) are only being discussed anecdotally. You should consult with an attorney in the appropriate state to ensure that you understand the community property laws that apply to residents of that state.
   2. *Opt*-In States. There are at least three states that are separate property regimes, but allow some form of “opting in” to their form of community property ownership.
      1. Florida. Many individuals migrate to Florida following marriage, with a significant portion of such individuals coming from Latin American jurisdictions where community property is the dominant marital property regime. Thus, Florida is home to many individuals who were formerly subject to a community property regime. Prior to the adoption of the Community Property Trust Act, planners were faced with uncertainty regarding the creation of “joint trusts” as a means of preserving the community property nature of these assets. The new law offers more guidance for structuring such trusts.
      2. Alaska. Functions like other community property regime, but residents must choose to opt in if they want it to apply.
      3. Oklahoma. Comm’r v. Harmon, 323 US 44, 48-49 (… an assignment of income to be earned or to accrue in the future, even though authorized by state law …, is ineffective to render the income immune from taxation as that of the assignor.”) However, this case pre-dated IRC 1014(b)(6)).
   3. *Presumption of Marital Property*. Under Wisconsin’s marital property laws, assets acquired by a married couple after the determination date are presumed to be marital property.
   4. *Determination Date*. The determination date is the later of:
      1. January 1, 1986.
      2. Date of marriage.
      3. Date both spouses are domiciled in Wisconsin.

*Ex. 1:* Jack and Diane were married in 1976 and have always lived in Wisconsin. *Their determination date is January 1, 1986*.

*Ex. 2:* Jack grew up as a resident of New York, while Diane grew up as a resident of Wisconsin. They met in 2018 while they were students together at UW Madison. After college, they moved to Manhattan for work where they currently live. They were married in Madison in the Spring of 2022 and are planning to move back to Wisconsin next year to be closer to Diane’s family. *Their determination date will be the date that they both move back and establish Wisconsin residency.*

*Ex. 3*: Jack and Diane were both previously married and divorced. Jack has always lived in Chicago while Diane currently lives in Milwaukee. They met at a Cubs game in 2020 and were married in 2021. Jack frequently stays with Diane at her home in Wisconsin, but still maintains his condominium in Chicago, Illinois. He plans to sell his condominium and move to Wisconsin after his youngest child graduates from high school next year. *Their determination date will be the date Jack establishes Wisconsin residency.*

* 1. *Individual Property*. Individual property includes the following:
     1. Property acquired before the determination date.
     2. Property acquired by gift or inheritance before or after the determination date.
     3. Principal appreciation on a spouse’s individual property *unless* that appreciation is substantial and results from the spouse’s undercompensated efforts. (*Wis. Stat. §§766.31 & 766.63*)

*Example 1*: Before getting married, Stedman purchases a run-down property in Lake Geneva, Wisconsin. He and Oprah then get married and live together in Milwaukee, Wisconsin. Following their wedding, Stedman spends every weekend for the next year improving the property. He then sells the property for nearly double the purchase price. *The vacation property is Stedman’s individual property because he acquired it before the determination date; however, the appreciation on the property is marital property because it was substantial and resulted from Stedman’s uncompensated efforts.*

*Example 2:* Oprah inherits a distressed business from her mother when her mother dies. Over the next five years, Oprah works 60-70 hrs/wk growing the business. She pays herself a reasonable salary. Oprah then sells the business for a 10x multiple. *The business is Oprah’s individual property because it was inherited property. The appreciation on the business is also Oprah’s individual property because it resulted from her efforts, for which she was reasonably compensated. NB: Oprah’s salary for the past five years was marital property.*

* 1. *Classification of Income.* All income, including income on non-marital property, is classified as marital property unless specifically reclassified as individual property by a Marital Property Agreement or a Unilateral Statement, or if it was received as spousal gift. *Wis. Stat. §766.31*

1. **Tax Issues**
   1. History of IRC Section 1014(b)(6) – “… one of the largest tax loopholes in the Internal Revenue Code … (Ware, Jeremy T., Nevada Law Journal 5 Nev. L.J. 704 (2005)).
      1. General Principal – State Law Controls. Federal law determines how property is taxed, but state law determines whether, and to what extent, a taxpayer has “property” or “rights to property” subject to taxation. (See, Aquilino v. United States, 363 U.S. 509 (1960); Morgan v. Commissioner, 309 U.S. 78 (1940)). Thus, federal tax is assessed and collected based upon a taxpayer’s state created rights and interest in property. This interplay of federal and state law requires an understanding of relevant state property laws to properly analyze community property issues. For income tax purposes, if spouses file separate returns, each spouse is taxed on 50% of the total community property income regardless of which spouse acquired the income (See, Poe v. Seaborn, 282 U.S. 101 (1930)). In addition, each spouse is taxed upon 100% of his or her separate property income. Community property also affects income tax basis in property.
      2. Understanding a brief history of this section sheds light on both its interpretation and possible future modifications. The origins of this section date back to decedents dying after December 31, 1947.
         1. In the late 1940’s, there were far less dual income households than there are today. While the data is a little hard to pin-point, according to Pew Research Center,
            1. In 1960, Only the father was employed in 70% of households, compared to 25% of all households having dual income and 2% where only the mother was employed (outside the home).
            2. In 2012, Only the father was employed in 31% of households, compared to 60% of all households having dual income and 6% where only the mother was employed (outside the home).
            3. The breakeven of the percentage of households where only the father was employed (outside the home), versus dual income percentages occurred in the early 1980’s.
         2. Therefore, in a common law state, the husband’s separate common law property usually comprised the entire household’s property, such that if the husband were to die first (which was statistically more likely to happen among spouses the same age and of the opposite gender), all of the property would receive the basis step up.
         3. However, in a community property state, where the husband’s earnings are community property, at death, he could most likely only step up his half of the couple’s property. This is what caused the inequality between common law basis step up rules and community property basis step up rules.
         4. These points were made in the Ninth Circuit, “Section 1014(b)(6) was designed to equalize the incidence of taxation between community-property and common-law states.” Willging v. United States, 474 F.2d 12, 14 (9th Cir. 1973). See also S.Rep.No 80-1013, at 29 (1948). Willging went on to state the statute was not designed, “… to provide a special benefit to community-property taxpayers.” (Willging, 474 F. 2d at 14).
         5. *Rev. Rul. 87-13* (which makes clear that “community property” includes “marital property” and therefore the full step up in cost basis applies to Wisconsin marital property)
      3. Uniform Disposition of Community Property Rights at Death Act (Uniform Act).
         1. The Uniform Act has been adopted in fourteen common law states (including Florida and Minnesota, but not Illinois).
         2. The Uniform Act does not state it preserves the community character of community property; only that it causes it to be disposed of in a similar manner at death.
         3. Commentators are split on the application of the Uniform Act to income tax basis.
         4. Field Service Advisory (FSA) 1993 WL 1609164 (IRS treated property held in Oregon (which had adopted the Uniform Act) as community property. Married couple sold their residence in California and bought a new home in Oregon, jointly, with the proceeds. Residence was allowed a full step up in basis.)
         5. Fla. Stat. §§ 732.216-732.228*,* (personal property that was acquired as or became marital property under the laws of another jurisdiction, was acquired with rents, income or proceeds from or in exchange for marital property or is traceable to marital property shall continue to be recognized as marital property).
   2. Internal Revenue Manual Section 25.18.1
      1. This IRM section addresses the basic theory and principles of community property law, providing the proper method of analysis to be utilized in determining whether property is community property. It discusses some of the state law differences between community property states. However, this IRS is not a substitute for working with state law. Rather, it must be read in conjunction with the laws of the applicable community property state.
      2. For federal tax purposes, a taxpayer’s rights and interest in property are determined under the laws of the taxpayer’s state of domicile. Therefore, to determine how income should be reported, it may be necessary to determine domicile at the time that property or the right to property was acquired. Since a taxpayer’s domicile may change over the period being examined, it may be necessary to allocate property and determine tax consequences under the laws of more than one state.
      3. Domicile and residence are not the same. A person may have several places of residence, but only one domicile. A temporary place of abode may be a residence, but domicile is based on the individual’s intent to make the home permanent. It is the place a person has his or her true, fixed, permanent home and principal establishment and to which, whenever absent, he or she has the intent of returning (Smith v. Smith, 206 Pa. Super. 310, 213 A..2d 94 (1965)).
   3. One Year Waiting Rule – 1014(e). If appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death; and such property is acquired from the decedent by (or passes to the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
   4. IRC Section 754 Election and related issues. This election allows an entity taxed as a partnership to adjust the basis of property within a partnership under IRC sections 734(b) and 743(b) when one of two triggering events occur: (yy) a distribution of the partnership property; or (zz) certain transfers of a partnership interest (including death).
      1. Partnership makes a 754 election and adjusts the basis pursuant to Sec. 743(b).
      2. The adjustment is equal to the transferee partner’s initial basis in the partnership, less his proportionate share of the adjust basis of the partnership assets.
      3. Section 755 provides guidance regarding how to allocate the adjustment
      4. 754 is irrevocable without consent from IRS.
      5. Made on an asset by asset basis – regulations provide guidance.
2. **Altering the Impact of Wisconsin’s Marital Property Law**

There are several ways that a couple can alter the impact of Wisconsin’s Marital Property Law, as follows:

* 1. *Marital Property Agreement*. Under *Wis. Stat. §766.58,* a couple can alter the impact of Wisconsin’s Marital Property Law in writing, either before marriage (with a premarital agreement that becomes effective upon marriage) or after marriage (with a post marital agreement that becomes effective when signed but can have retroactive effect).
     1. *Requirements for Validity*. In order to be valid, a Marital Property Agreement must be conscionable, must be signed voluntarily and must contain adequate disclosure. In determining whether a MPA is conscionable, a divorce court will look at whether enforcement of the MPA would create inequity due to changed circumstances. In considering whether a MPA was signed voluntarily, courts consider when the agreement was signed, any age difference between the spouses and any family pressures that existed. Lastly, there must be adequate disclosure as to each spouse’s existing assets, liabilities, interests in trust and expectancies.
     2. *Reasons to Create.* Spouses may choose to execute a MPA for a variety of reasons, including:
        1. *Classification of Property Generally*. Spouses may choose to opt in or opt out of Marital Property Law. This is particularly helpful in situations where each spouse has predetermination date property or other individual property. Executing a MPA provides clarity and avoids comingling issues. Unless specifically stated otherwise in the agreement, classification of property in a MPA will override title, even recorded title.
        2. *Classification of a Specific Asset.* Spouses can execute a MPA to classify a specific asset, including any income and appreciation on that asset, as the individual property of one spouse. This can be used as a creditor protection tool to segregate an asset and protect it from the other spouse’s potential creditors. *NB:* Classifying an asset as the individual property of one spouse means that it will not receive a step up in cost basis upon the death of the other spouse.
        3. *Provide for Management and Control of Property.* Spouses can agree in a MPA as to both the classification of property, as well as the ownership and control of property. For example, spouses could agree that certain property should be classified as marital property, but that only one spouse has management and control rights over said property.
        4. *Establish/Eliminate Spousal Support Obligations.* Spouses can agree to eliminate deferred marital property rights that would otherwise apply at death. Deferred marital property rights are akin to elective share rights in other jurisdictions. Deferred marital property includes pre-determination date property that would have been classified as marital property if it had been acquired while Wisconsin’s Marital Property Act was in effect. It extends to both probate and non-probate assets. The concept of deferred marital property represents an aggregate pecuniary amount rather than one-half of each individual asset.
        5. *Division/Distribution of Property Upon Dissolution of Marriage.* A MPA can govern the division of property upon divorce. This type of agreement is not specific to Wisconsin Marital Property Law. It requires each spouse to be separately represented.
        6. *Division/Distribution of Property Upon Death.* A MPA can govern the distribution of property upon the death of either spouse. It can, but does not necessarily, require each spouse to be separately represented.
        7. *Probate Avoidance.* In Wisconsin, a married couple can avoid probate by invoking Wis. Stat. 766.58(3)(f) in their MPA and directing where assets that would otherwise be subject to probate should pass upon each of their deaths. This is commonly referred to as a “Washington Will provision.” Often this provision is drafted so that assets pass to the couple’s joint revocable trust at either death. The provision becomes ineffective if either or both spouses become residents of another state prior to death.
  2. *Unilateral Statement.* Under *Wis. Stat. §766.59*, a spouse can unilaterally classify income from non-marital property as individual property. Since the default rule in Wisconsin is that income on individual property is marital property, a unilateral statement that classifies income on non-marital property as individual property avoids comingling issues. In order for a unilateral statement to be valid, it must be signed and notarized by the spouse who owns the property, and notice must be given to the non-owner spouse within five days. If notice is not given within five days, the statement is still valid; however, the failure to provide notice gives rise to a breach of duty of good faith between spouses under *Wis. Stat. §766.15.* A unilateral statement does not control in the event of a divorce.
  3. *Spousal Gift.* Under *Wis. Stat. §766.59*, spouses can make gifts to one another of individual or marital property. Except in the case of a fraudulent conveyance, spouses can use spousal gifts as a way to limit the rights of creditors.
  4. *Court Decree.* A court with proper jurisdiction can classify property as marital or non-marital property.
  5. *Comingling of Marital and Non-Marital Property.* When non-marital property mixes with marital property, it becomes comingled and is treated as marital property unless the non-marital assets can be traced. *See Wis. Stat. §766.63.* 
     1. Courts and IRS seem to presume the validity of commingling transmutations.
        1. Sweeney v. Commissioner, Sweeney v. Comm’r, 15 BTA 1287, 1292-93 (1929) (IRS argued various properties of a deceased husband were his separate property and were taxable at 100% for federal estate tax purposes. Wife argued it was commingled in a common account and transmuted by agreement and only half of the property should be subject to the estate tax. Court ruled, “In consideration of both of the commingling of the property and of the express agreement between the parties, we hold that the entire property formerly owned by the decedent and [the wife of the decedent] … was community property).
        2. Rev. Ruling 87-98. Couple domiciled in a community property state took title to real property as joint tenants with rights of survivorship, a common law form of separate property ownership, raising a presumption of transmutation from community to separate property under state law. Even though the title of the property indicated possible separate ownership because the couple indicated in their wills they considered the property to be community property, the presumption was overcome under state law.
     2. Agreements to Live in Universal Community. Similar to commingling, couples in some community property states can enter into agreements to live in universal community that effectively transmutes all their separate property into community property under state law – even after acquired property.
  6. *Tracing*. As discussed above, commingled property becomes community property unless the separate property portion can be traced. Tracing is done by allocating withdrawals, deposits or payments between community property funds and separate property funds. The burden of proof is usually on the party attempting to rebut the community property presumption created under state law. (See IRM 25.18.1.3.24 (02-15-2005)).

1. **Creditor Rights Under Marital Property Law (*Wis. Stat. §766.55)***
   1. *During Lifetime of Both Spouses.* 
      1. *Marital/Family Debts.* Debts incurred in the interest of marriage and/or family can be satisfied from *all* marital property, as well as the incurring spouse’s interest in non-marital property. While both spouses are alive, debts of either spouse are presumed to be incurred in the interest of marriage and/or family. This is a rebuttable presumption and is a question of fact. The burden of proof lies with the debtor to prove that a debt was not incurred in the interest of marriage and/or family. If the presumption is successfully rebutted, it can protect the non-incurring spouse’s half of marital property. *NB:* Caution should be used when renewals/refinancing of pre-determination date debt. The renewal or refinancing is considered a new extension of credit and could convert an individual debt to a debt incurred in the interest of marriage and/or family.
      2. *Doctrine of Necessaries (common law).* The doctrine of necessaries applies to necessary goods of services obtained for the benefit of one spouse, such as medical expenses. Both spouses are personally liable for these debts if they were incurred post-determination date and creditors can recover from all marital and non-marital property of both spouses. A pre-determination date creditor is entitled to recover from all pre-determination date property of the incurring spouse, as well as all other post-determination date property that would have been property of the incurring spouse but for the marriage.
   2. *Upon Death of One Spouse.* Upon the death of one spouse, the deceased spouse’s estate becomes a tenant in common with the surviving spouse as to all marital property. Debts incurred in the interest of marriage and/or family can be satisfied only from the incurring spouse’s interest in marital property and the incurring spouse’s interest in non-marital property. The surviving spouse’s right to receive non-probate transfers are *not* subject to the claims of creditors, unless the doctrine of necessaries applies. To the extent the surviving spouse receives assets from a deceased spouse as a result of a transfer on death designation, beneficiary designation, joint tenancy or as survivorship marital property, those assets are not recoverable by creditors.
   3. *Effect of Marital Property Agreement and/or Unilateral Statement on Creditor Rights.* In order for a MPA or a unilateral statement to be effective as to creditors, creditors must have actual knowledge of the agreement or statement.
2. **Cross-Border Issues**
   1. *Martial Property Classification.* Once one or both spouses leave Wisconsin, no new Wisconsin marital property can be created. Most states, however, will recognize marital property brought from another state. One key reason to maintain the marital property classification is for the step up in cost basis over both spouses’ interests.
   2. One of three outcomes
      1. Common law state may hold that when a couple moves to the state, or exchanges separate property there, their community property automatically transmutes to some form of separate common law co-ownership. Here IRS will not likely allow a full step up. Rozan v. Rozan (California couple bought North Dakota land with community property. California Court found the North Dakota real estate was thus community property but recognized it could not affect title to the land in another jurisdiction. North Dakota Supreme Court held, “The use of community funds did not impart the status or character of community property, with all its varied and unique incidents, to the so acquired North Dakota lands. Upon acquisition, using community property funds, each party in this instance acquired a separate yet undivided one-half ownership interest in the North Dakota real property…”
      2. Some common law states preserve the community property character of the transported property (i.e., marital domicile). Here the IRS will probably allow the full step up, but the issue is unclear. Quintana v. Ordono (Husband domiciled in Cuba, a community property jurisdiction, purchased stock with money he earned in Florida, a common law jurisdiction. (Holding the stock was community property).
      3. Some common law states have community property opt-in.
   3. Rev. Ruling 68-80 (Couple moved from New Mexico (community property) to Virginia (common law)). Couple exchanged community property for Virginia real property, holding it as tenants in common. IRS stated the surviving spouse cannot take the full step up since “there is nothing in the Internal Revenue Code or regulations that would indicate section 1014(b)(6) of the Code was intended to include separate property that had previously been converted from community property to separate property.”
   4. *Case Studies.* 
      1. *Case Study #1*: Spouse #1 and Spouse #2 were married at age 26 and lived in Wisconsin for the first 30 years of their marriage where they started and grew a successful business. They also had three children together. They have a Will and a Joint Revocable Trust, but no marital property agreement. They recently sold their business for $50,000,000 and have moved to Florida. They scheduled a meeting with their Florida estate planner. What should their Florida estate planner consider?
         1. Confirm that clients have correctly changed residency to Florida.
         2. Determine marital property classification of existing assets.
         3. Consider advantages to preserving existing marital property.
         4. Decide how to structure Florida estate plan - sever joint revocable trust?
         5. How does probate avoidance change?

Their Florida estate planner decides to recommend that Spouse #1 create a SLAT for the benefit of Spouse #2 and that Spouse #2 create a GST dynasty trust for their descendants.

1. How will marital property affect creation of SLAT?
2. How will marital property affect creation of GST dynasty trust?

Several years later, Spouse #2 dies. Assuming no changes have been made to the classification of their property, how will their assets be treated as a result of Spouse #2’s death?

3. What if an agreement stating no change of ownership form will occur upon moving to a common law state (assuming it would be valid in the new state?

4. What about funding a revocable inter vivos trust with community property and selecting the law of the community property state as governing law?

* + 1. *Case Study #2*: Same facts as above, but Spouse #1 and Spouse #2 lived in Florida for the first 30 years of their marriage and have recently moved to Wisconsin. What should their Wisconsin estate planner consider?
       1. Can the Wisconsin estate planner ethically represent both spouses?
       2. Should their assets be classified as marital property?
       3. How should future income and appreciation on their assets be classified?

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