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# Estate, Gift & Income Tax Aspects of Virginia's Transplanted Community Property

## - A Primer -

by

J. Rodney Johnson\*

Almost a quarter of a century has now passed since the Virginia Supreme Court officially recognized the existence of transplanted community property in this state in the landmark case of *Commonwealth v. Terjen*, 197 Va. 596, 90 S.E. 2nd 801 (1956). In this case, involving a California couple who sold their community-property owned residence in California and brought the proceeds along with them when they moved to Virginia, the Court held: "A change of domicile from a state where the community property law prevails to a common-law state does not affect the community property character of property previously acquired." Thus community property not only does exist in Virginia, it is believed to exist on a reasonably extensive basis in some areas of the state and to a limited extent in every area of the state. A rough idea of the magnitude of this problem of "transplanted" community property in Virginia and the other common-law states can be derived from a comparison of the great number of Americans who live in the community-property states with the statistics relating to the mobility of the American people. According to the Statistical Abstract of the United States the eight community-property states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington contain 21.5% of the Population of the United States — a total of 46,339,000 individuals. According to this same source, approximately four to five million persons moved from these community-property states to other states during the five-year period 1970-75. How many of these four to five million persons might have moved to Virginia during this five-year period is of course quite speculative. It would be even more speculative to attempt an estimate of the total number of persons currently domiciled in Virginia who were domiciled in a community-property state at any time in the past. However, it can reasonably be assumed that there are a number of such persons, and it is a matter of non-debatable law that "...their change of domicile... (did) not affect the community character of property previously acquired" by them and brought into Virginia. *Commonwealth v. Terjen*, supra.

The recognition of the number and variety of problems that this transplanted community property is creating for Virginia attorneys, lenders, fiduciaries, title companies and others prompted the introduction of HB 278, The Uniform Disposition of Community Property Rights At Death Act, into the 1980 Session of the General Assembly. This Act would provide some sorely needed rules, guidelines and presumptions for those who are dealing with the disposition of transplanted community property in Virginia upon the death of the

parties. Although this bill was carried over to the 1981 session for further study, it is anticipated that it will become law at that session because it is of positive benefit to the consumer as well as the interest groups previously named and it does not impact negatively upon any interest group. Although the passage of this Act will go a long way toward providing solutions for the many property problems associated with the passage of transplanted community property upon the death of the parties, it will not affect the federal tax consequences associated with the passage of this property. It is these tax consequences that this short article is concerned with.

## DEFINITIONS

Prior to beginning a discussion of the estate, gift and income tax consequences associated with transplanted community property (hereafter TCP), it is imperative to have a firm grasp of four basic terms, several of which are quite easily confused with each other. First of all, separate property (SP) refers to the property of a married person that was acquired before the marriage as well as property acquired by gift, will or intestate succession during the marriage; community property (CP) refers to all property or income acquired by either spouse during the marriage other than by gift, will or intestate succession; separate property that results from converting community property (SP/CCP) refers to those instances where a husband and wife have made an equal division of their CP, either by dividing a particular asset(s) into two equal shares, by each taking different CP assets of equal value pursuant to an agreement to convert the same into separate property, or by converting the CP into some form of co-ownership between them such as a tenancy in common or a joint tenancy; and, lastly, separate property that results from giving community property (SP/GCP) refers to those instances where a married person gives all or a portion of his undivided one-half interest in one or more community property assets to the other spouse. Note the mixed usage of the last two definitions in a case where there is an unequal division of CP. If, for example, the legendary Blackacre is partitioned between H and W with H receiving 60% and W receiving only 40%, then W's 40% is entirely SP/CCP while H's 60% interest in Blackacre is composed of 50% as SP/CCP and the other 10% is SP/GCP. The concept of tracing is applicable in the following discussion of tax consequences and, once an asset has been properly identified, the identification continues to be applicable to all or the proportionate part of any other property acquired with the rents, issues, or income of, or the proceeds from, or in exchange for, the original asset.

## GIFT TAX RULES

The concept of community property springs from early concepts of Spanish law that, for property purposes, recognized the relation of husband and wife as a real partnership in the economic sense. As a logical derivation of this recognition, the earnings of both partners belong to them equally, regardless of whose name may be on the paycheck or asset when it is acquired and regardless of

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whether both of them are employed outside the home or whether only one is employed outside the home while the other remains at home in a supportive role. Thus the mere conversion or partition of CP into SP (resulting in SP/CCP) does not result in a gift for federal gift tax purposes any more than it would when any two business partners make an equal division of assets between themselves. It is only when one of the spouses gives away a portion of his vested, undivided, one-half interest in CP to the other spouse (causing her to receive SP/GCP) that a gift will have been made. In such a case, the \$3,000 annual exclusion of IRC 2503(b) will of course be available if the gift is of a present interest. However, while the inter-vivos marital deduction is allowable in connection with a gift of SP/GCP per IRC 2423(f) (4), the inter-vivos marital deduction is not allowable in connection with either the donor's one-half interest in CP per IRC 2523(f) (1), or the donor's SP/CCP per IRC 2523(f) (3). Any gifts made by H and/or W to third parties would be treated as one would logically expect, with H and W both having to join in the gift if it is their community property that is being given, and with H and W having the option to elect split-gift treatment under IRC 2513 when the property being given is the interest of only one of them in the community property.

#### ESTATE TAX RULES

When a Virginia domiciliary dies leaving TCP in his estate, only one-half the value of the CP has to be included in his federal gross estate, per IRC 2033, because the ownership of the other one-half has been vested in the surviving spouse since the time of its acquisition. Historically the marital deduction has not been allowed in connection with the one-half of the CP included in the decedent's gross estate. The mechanics for the computation of the adjusted gross estate have insured this result by excluding from the adjusted gross estate (1) all true CP included in the gross estate per IRC 2056(c) (2) (B) (i), (2) the proportionate amount of IRC 2053 and IRC 2054 deductions attributable to the foregoing per IRC 2056(c) (2) (B) (iv), and (3) all SP/CCP plus the proportionate amount of IRC 2053 and IRC 2054 deductions attributable thereto per 2056(c) (2) (C) (i). The distinction between SP/CCP and SP/GCP is recognized at this point, however, and IRC 2056(c) (2) (C) (ii) expressly provides for the inclusion of SP/GCP in the computation of the adjusted gross estate in order to determine the amount of the potential marital deduction.

In looking at the new \$250,000 "mini-max" marital deduction created by the Tax Reform Act of 1976, it appears that the intent of Congress was to parallel the treatment currently being given the standard marital deduction vis-a-vis community property considerations by reducing the "mini-max", dollar for dollar, for all such property found in the estate. And, in fact, IRC 2056(c) (1) (C) does just that in connection with true CP. However Congress failed to provide any specific language requiring the reduction of the "mini-max," in connection with any SP/CCP that might be in the estate. Whether this loop-hole will be closed by Congress, by the courts, by the service or whether it will remain open, as well as the estate planning potential thereof is of course speculative at this point.

Lastly, it should be noted that while neither CP nor SP/CCP can be used in computing the amount of the standard marital deduction, and while all CP in the estate will reduce the "mini-max" marital deduction dollar for dollar, there is no problem presented by using either CP or SP/CCP to obtain the marital deduction. In other words, once the amount of the potential marital deduction is computed as outlined above, then that marital deduction can be obtained by "passing" an equivalent amount of the decedent's CP or SP/CCP to the surviving spouse.

#### INCOME TAX RULES

A major benefit associated with community property is that upon the death of either spouse all of their community property will obtain a stepped-up basis under IRC 1014(b) (6) even though only the decedent's one-half has to be included in his estate tax return. While this may seem strange indeed — allowing a step-up in connection with the surviving spouse's half interest that is not included in the gross estate and not subject to estate tax on the death of the first to die — it is intended to be a rough parallel to the common-law case where although all of the property is included in the gross estate as a beginning proposition, one half is later taken out by the marital deduction. The reduction of the taxable estate by the amount of the marital deduction does not cause the basis of the property used to satisfy the marital deduction to lose its step-up in this latter case and thus the non-taxability of the surviving spouse's half interest in the community property should not prevent her from receiving a stepped-up basis either.

Notwithstanding the clear provision for this result, there are several innocent-appearing pit-falls lying in wait for the unwary that will prevent the application of the rule. The first problem deals with SP/CCP. As has been seen already, SP/CCP is treated as if it were true CP for purposes of computing the adjusted gross estate per 2056(c) (2) (C) (i). It would seem only logical, then, that such SP/CCP would benefit from the stepped-up basis rule of 1014(b) (6) as to both halves. This has not proven true. In Rev. Rul. 68-80, 68-1 CB 348, a New Mexico H and W who owned realty as CP moved to Virginia in 1965 and traded their New Mexico CP for Virginia realty to which they took title as tenants in common. Upon H's death in 1966 he devised his one-half interest in this Virginia realty to W. The ruling held that although this SP/CCP was to be treated as CP for purposes of disallowing any marital deduction in connection therewith, per IRC 2056(c) (2) (C) (i), it was not entitled to a stepped-up basis for the surviving spouse's one-half because IRC 1014(b) (6) deals with CP only and its benefit does not extend to SP/CCP. Many Virginia attorneys will want to preserve the identity of TCP in Virginia for a variety of reasons and in a number of cases the vehicle chosen to segregate this property from the remainder of the estate will be the inter-vivos trust. In fact the inter-vivos trust is ideally suited for this purpose. Rev. Rul. 66-283, 66-2 CB 297, deals with such a case and discusses the requirements that are necessary in order for H and W to be regarded as continuing to own the corpus of the trust as CP (as opposed to

SP/CCP) and thus to be entitled to the stepped-up basis provision of IRC 1014(b) (6) as to the entire corpus upon the death of the first of them to die.

In closing it should be noted that no attempt has been made to state every tax rule associated with CP, SP/CCP or SP/GCP in Virginia, or to indulge in an exhaustive discussion of those points that were mentioned. It is believed, however, that the foregoing does live up to its title — a primer. For those who wish to pursue the subject further, the definitive property work is deFuniak and Vaughn's Principles of Community Property (2nd ed. 1971) U. Arizona Press; and, for tax purposes, the national treatises as well as the local treatises published in the community property states appear to be the best sources.

## GMU Law School Graduates 1st Class

George Mason University and its new School of Law in Northern Virginia recently held a day-long celebration to mark the school's new stature as part of George Mason and the graduation of its first class since it received accreditation by the American Bar Association (ABA). The observance included a morning dedication program and an afternoon graduation ceremony, at which former Watergate Prosecutor Leon Jaworski addressed a crowd of more than 1000.

Jaworski warned the 265 graduates and their guests that the nation may be on the verge of another era of violence similar to the student revolts of the 1960s. Noting the current tendency of public servants, such as striking teachers, police and firefighters, to violate court orders, he said that he sees a new cycle of disdain for the law beginning again. "The only difference," stated Jaworski, "is that the rule of law is being flouted by the older generation with greater abandonment than ever before."

The morning ceremony was an occasion to thank the many legislators and community leaders who worked to achieve state approval for the merger of GMU and the former International School of Law, and for the accreditation by the ABA of the GMU School of Law. Virginia Lieutenant Governor Charles S. Robb, Attorney General J. Marshall Coleman, and Secretary of Education J. Wade Gilley addressed the gathering, Gilley bringing the official recognition of the law school from Governor John N. Dalton.

Coleman, representing the legal community, spoke about George Mason's unique physical location, which enables it to draw on the assets and strengths of Northern Virginia and the nation's capital. "This law school," said Coleman, "can be a national leader in the development of innovative programs designed to solve the increasingly complex problems of urban development, programs in urban planning and land use, in energy and mass transit."

In the morning's major address, Robb, speaking on the mission of legal education, noted that lawyers need both theory and practical experience. He warned, however, that internships should not take away from the fundamentals of an analytical education.



A family of four pauses to examine free VSB public service pamphlets at the State Bar Young Lawyers Conference's "Ask A Lawyer" exhibit at the 1980 State Fair, Sept. 18-28 in Richmond.

## "Ask A Lawyer" State Fair Program Draws Nearly 1,000 Persons

Nearly 1,000 members of the general public received free 10-minute consultations from lawyer volunteers through the "Ask A Lawyer" program conducted September 18-28 at the 1980 Virginia State Fair in Richmond. The lawyer volunteers were arranged by the Virginia State Bar (VSB) Young Lawyers Conference.

In addition, several thousand fairgoers paused at the program's panelled law office in the fair's Commonwealth Building to pick up one of several free VSB informational public service pamphlets on a variety of legal topics.

About 70 Richmond-area lawyers and 50 legal secretaries donated their time to staff the program office from noon until 10 p.m. throughout the course of the fair. The volunteer recruiting effort was spearheaded by Attorney Carter Glass, IV, of Richmond. With pre-fair news coverage of the exhibit by several Richmond radio stations and a report on the exhibit by a Richmond television station during the fair, the "Ask A Lawyer" exhibit was able to increase the number of persons whom it served significantly over past years.