

## COMMUNITY PROPERTY WITH RIGHT OF SURVIVORSHIP What is it, and why use it?

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California has adopted a new form of property ownership available to married couples – community property with right of survivorship<sup>1</sup> (“CPWROS”). This form of title was created to allow a surviving spouse to avoid probate with respect to jointly-held assets while at the same time obtaining the “stepped-up” basis afforded to community property.

In this article, we’ll discuss what CPWROS is, how it is treated for tax purposes, and where it fits in estate planning.

### Background

Where married persons hold property outright, (i.e., not in trust), they ordinarily hold title thereto as either (i) joint tenants with right of survivorship, or (ii) community property. Each form of title and its accompanying advantages and disadvantages is discussed below.

Joint tenancy is a form of concurrent ownership – i.e., ownership by two or more persons at the same time. With a joint tenancy, each joint tenant’s interest must be created by the same instrument, each interest must be equal, and each tenant must have the same rights and obligations respecting the property.<sup>2</sup> If the instrument fails in any way to meet these requirements, the interest created is normally treated as a tenancy in common. The most compelling feature of a joint tenancy is the so-called “right of survivorship” – upon the death of a joint tenant, the deceased tenant’s interest passes to the surviving joint tenants in equal shares by operation of law. The property passes without probate administration. In order to convey the decedent’s interest to the survivors at the death of a joint tenant, the surviving joint tenants need only file an affidavit of survivorship coupled with a copy of the decedent’s death certificate.

California is one of a handful of states that utilizes the community property system for property owned by married persons.<sup>3</sup> The general presumptions are quite straightforward – any property acquired during the marriage (and the income earned therefrom) is presumed to be community property; conversely, separate property includes all property acquired by a person before marriage, as well as property acquired during marriage by gift, devise or descent, (plus the income it generates).<sup>4</sup> (As simplistic as these rules appear to be on the surface, in practice, the distinction between community and separate property can sometimes be difficult to make.<sup>5</sup>) Each spouse has an equal interest in any community property<sup>6</sup>, and each spouse owes a fiduciary

duty to the other respecting such property.<sup>7</sup> Unlike property held in joint tenancy, each spouse has complete testamentary control over their one-half interest in community property. There is no right of survivorship. This means that any testamentary transfer is generally subject to administration.<sup>8</sup>

Creditors' rights to property at the death of an owner will vary, depending upon the form of ownership interest in which the property was held at death. In the case of an interest held by the decedent as community property, creditors may reach the decedent's interest after the decedent's death following the normal rules of estate administration.<sup>9</sup> In the case of a joint tenancy, however, because the decedent's joint interest terminates at death, the decedent's creditors have no right to joint tenancy property.<sup>10</sup>

Where does CPWROS fit into the scheme of things? As you can see from the preceding discussion, joint tenancy and community property have much in common. Each is a form of concurrent ownership with respect to which each co-tenant owns an equal undivided interest in the jointly-held property, and each owes fiduciary-like duties to the other co-tenants respecting that property. The two key differences are (i) the right of survivorship inherent in a joint tenancy, and (ii) *post mortem* creditors' rights respecting each form of title. CPWROS eliminates one of these differences – the lack of a right of survivorship respecting community property – while preserving the other – a creditor's ability to reach the decedent's one-half interest in the property passing to the surviving spouse.<sup>11</sup> Thus, like property held in joint tenancy, it passes to the surviving spouse by right of survivorship without administration.<sup>12</sup> By the same token, it may be reached by the decedent's creditors in the same manner as ordinary community property.

## **Tax Treatment**

The taxation of a decedent's interest in concurrently owned property for estate tax purposes will vary, depending upon the form of ownership. §2040 provides three different rules of inclusion for joint tenancies. These rules vary depending upon how the property was acquired and who the joint tenants are. In pertinent part, §2040(b) provides that where the joint tenancy is between spouses only, (i.e., there are no joint tenants other than husband and wife), one-half of the value of the joint tenancy property is included in the decedent joint tenant's gross estate.<sup>13</sup> §2033 pulls into the gross estate any property interests subject to the decedent's testamentary power of disposition. Thus, community property is generally reportable under §2033. The gross estate will only include the fair market value of the one-half interest owned by the decedent.<sup>14</sup>

Depending upon the form of title and the relationship of the successor, there can be different basis implications for the survivors. §1014(a) generally provides that the basis

of property in the hands of a person acquiring the property from a decedent shall be the fair market value of the property at the date of the decedent's death.<sup>15</sup> §1014(b) generally provides that property is treated as having been acquired from a decedent to the extent the successor receives an interest in property which was included in the decedent's gross estate for estate tax purposes. In addition, §1014(b)(6) provides that property which represents the *surviving spouse's* one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, etc., is treated as having been acquired from a decedent if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate. Thus, if the tenancy is a joint tenancy, the interests received by surviving joint tenants will receive a fair market value, date of death basis to the extent the joint interest is included in the decedent's gross estate. (This will vary, depending upon the nature of the tenancy. See the discussion in footnote 13 below.) With respect to a joint tenancy between spouses only, this means the decedent's one-half interest receives a step-up in basis. However, the surviving spouse's one-half interest does *not* receive a basis step-up. §1014(b)(6) does *not* apply to the survivor's interest because it is *not* community property. If the property is held as community property, the successor receives a fair market value, date of death basis in the interest received from the decedent, *and* the surviving spouse receives a fair market value, date of death basis in her own community interest (by virtue of §1014(b)(6)).

How do these rules apply to CPWROS? First, it should be noted that the basis rules described above hinge on one important fact – that the decedent's one-half interest in the property in question is included in his gross estate for estate tax purposes. It has been averred by some commentators that, because the decedent's one-half interest in CPWROS expires at the decedent's death, there is no interest to include in the decedent's gross estate. Under this reasoning, §2033 does not apply (as it ordinarily does to community property) because at death, the decedent owns nothing. And §2040 is also inapplicable, because this is not a joint tenancy. And since there is nothing includible in the decedent's gross estate, the basis rules of §1014 don't apply.<sup>16</sup> This approach overlooks one important thing – the fact that the decedent's one-half interest may be reached by his creditors. The fact that a decedent's creditors may reach the decedent's property has been held sufficient grounds to include that property in the decedent's gross estate under §2038.<sup>17</sup> Consequently, the decedent's one-half interest in CPWROS is includible in his gross estate (under §2038), and as a result, §1014 will apply to provide for a basis step-up in both the decedent's *and* the surviving spouse's one-half interests. In short, CPWROS receives the same tax treatment as does ordinary community property.

### **Much ado ...?**

CPWROS, like virtually any device used in estate planning, is *not* a panacea. Even without CPWROS, a decedent has the power to transfer his one-half community

property interest to his surviving spouse without administration and obtain a basis step-up through the simple expedient of a nonprobate transfer (such as a living trust). By the same token, CPWROS takes its place as another useful tool in the estate planner's arsenal.

Who will use CPWROS? For starters, since CPWROS vests the surviving spouse with outright ownership of the decedent's one-half community property interest, it will only be used when the decedent wishes to provide the surviving spouse with such ownership – i.e., it won't be used in situations where the decedent desires to place the property in trust, or otherwise wishes to transfer the property to someone other than the surviving spouse. That said, CPWROS will be an effective tool for married couples whose combined estates have a value that is less than the applicable exclusion amount, (since in such instances, there is no need for traditional marital deduction planning). Even in larger estates utilizing any of the many marital/bypass trust combinations, CPWROS may be indicated for those assets that the decedent prefers to transfer to the surviving spouse outright, such as a personal residence.

Lastly, the advent of CPWROS is *not* the death knell for joint tenancies between spouses. Notwithstanding the relative tax advantages of CPWROS, in situations where the decedent has genuine concerns regarding creditors, holding property in joint tenancy may be preferable. (E.g., a professional such as a doctor may have legitimate fears that malpractice actions may be brought after her death. By holding her property with her spouse in joint tenancy, the jointly-held property will pass to her spouse at her death free of any such claims. The same would not be true of community property.)

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<sup>1</sup> Calif. Civ. C. §682.1, effective for instruments created on or after July 1, 2001.

<sup>2</sup> See Calif. Civ. C. §683. Note that some states also require that the instrument creating the tenancy use the words joint tenancy "*with the right of survivorship*" in order to create a true joint tenancy. California is not among them.

<sup>3</sup> Each state utilizing the community property system has its own rules, and the result obtained under one state's laws is not necessarily the result one will obtain under the laws of another state. This discussion is based solely on California law.

<sup>4</sup> See Calif. Fam. C. §760 *et. seq.*

<sup>5</sup> For example, if separate and community property have been commingled, the characterization of the property will depend primarily upon the recordkeeping talents of the spouses. If each fund can be ascertained, their character remains intact, and any income from the property will be shared on a pro rata basis. If the funds cannot be traced, the presumption is in favor of community property. Some courts have held that where the community element is negligible, the whole may be regarded as separate. (Cf. *Kershman v. Kershman*, 192 Cal. App. 2d 18 (1961).)

<sup>6</sup> See Calif. Fam. C. §751.

<sup>7</sup> See Calif. Fam. C. §1100(e).

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- <sup>8</sup> This rule is subject to one proviso. Any property passing *outright* to a surviving spouse is excluded from probate. (Note that this rule only applies to property passing “outright” to a surviving spouse. If the property passes to the surviving spouse in trust or in qualified ownership form, (e.g., joint tenancy or tenancy in common), it *is* subject to probate.) If a spouse so chooses, the property may be subjected to probate. (Cf. Calif. Prob. C. §13502. This election may be extended to include the surviving spouse’s one-half share of community property.) Where no election to probate spousal property is made, the spousal set-aside procedure of Calif. Prob. C. §13650 *et. seq.* is ordinarily resorted to. This procedure results in the confirmation of title in the surviving spouse’s name.
- <sup>9</sup> See, e.g., Calif. Prob. C. §7001. In California, this is also true of property held in a revocable living trust. (See, e.g., Calif. Prob. C. §19000 *et. seq.*)
- <sup>10</sup> In California, this is true even if the creditor has a judgment lien on the property. (See *Ziegler v. Bonnell*, 52 Cal. App. 2d 217 (1942).) To obtain an interest in such property, the creditor must sever the joint tenancy before the debtor’s death. (This rule has no application to creditors who have a secured interest in the jointly held property itself, such as a mortgage.)
- <sup>11</sup> See Calif. Civ. C. §682.1(a), which, among other things, specifically provides that CPWROS is subject to Calif. Prob. C. §13550 *et. seq.* §13551(b) allows creditors to reach that portion of the decedent’s one-half community property interest that passes to the surviving spouse without administration.
- <sup>12</sup> Calif. Civ. C. §682.1(a) provides that the survivor’s title is conveyed under “the same procedures as property held in joint tenancy”.
- <sup>13</sup> If there are any joint tenants other than spouses, (even if there are spouses among the joint tenants), §2040(a) provides the following rules. Where the joint tenancy property is acquired by the decedent and the other joint tenants by gift, bequest, devise or inheritance, the decedent includes his fractional share of the value of the joint tenancy property in his gross estate. In all other cases, the decedent includes the entire value of the joint tenancy property in his gross estate except to the extent *the executor can show* its acquisition is allocable to consideration furnished by any other joint tenant. (Put differently, we include in the gross estate a fractional share of the value of the whole property, with that fraction based upon the decedent’s proportionate share of consideration used to acquire the joint tenancy property.)
- <sup>14</sup> There are valuation differences between these ownership forms as well. Because of the fractional nature of these types of interests, valuation discounts are available for property held by the decedent as community property. In the case of property held in joint tenancy, however, no such discounts can be taken. (See *Estate of Young*, 110 T.C. 24 (1998)).
- <sup>15</sup> This is colloquially referred to as a “step-up” in basis. It is obvious, however, that since the statute refers to the fair market value on the date of death, this could just as easily be a step *down*.
- <sup>16</sup> Presumably, the decedent’s basis in his one-half interest would carry over to his successors.
- <sup>17</sup> See, e.g., Rev. Rul. 76-103, 1976-1 C.B. 293, where the Service ruled that §2038 was applicable to an irrevocable discretionary trust “because of the grantor’s retained power to, in effect, terminate the trust by relegating the grantor’s creditors to the entire property of the trust”.