HB 199

Alaska State Legislature

House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE
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COMMUNITY & REGIONAL AFFAIRS
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House Bill 199
Sponsor Statement

Income tax advantage of community property

A person who owns assets with his or her spouse as community property in one of the nine community property states (Louisiana, Texas, New Mexico, Arizona, California, Nevada, Washington, Idaho, and Wisconsin) has a major income tax advantage over a married person who owns assets with his or her spouse but that are not community property. This advantage results from the incongruous operation of the step-up in basis rule. This rule is one of the few, if only, income tax advantages that a person's estate receives upon his or her death.

The best way to explain the step-up in basis rule is to start with an example of a single person in Alaska on her death bed who twenty years ago paid $10,000 for a homestead that is presently worth $110,000. If the person sold the homestead before she died, she would realize a long-term capital gain of $100,000. The gain would be subject to a maximum capital gains tax of 28%, or $28,000. On the other hand, if the person decided not to sell the homestead and died the next day, the $100,000 profit would be forgiven. This means that her heirs could sell the homestead for $110,000 and pay no income taxes! This is because the original cost basis of $10,000 is "stepped-up" to $110,000, the fair market value of the homestead at death. If the homestead is sold for $110,000 with its new basis of $110,000, there is no gain and no income taxes will be owed.

The step-up in basis rule gets more complicated when a married couple is involved. If we assume that a married couple in Alaska bought the homestead twenty years ago for $10,000 and held title as husband and wife, then each would own one-half of the homestead. If the husband was on his deathbed and the couple sold the homestead before the husband died for its current fair market value of $110,000, the couple would realize a $100,000 long-term capital gain just like the single person did. However, if the husband died and the wife inherited his half of the homestead and then sold it, she would only realize only a $50,000 long-term capital gain. This is because the profit in the husband's half of the homestead would be forgiven by the step-up in basis rule. The husband's half

of the homestead would get a "step-up" in basis to $55,000. When the husband's half was sold for $55,000 there would be no gain. However, the wife would have a gain on the sale of her half of the homestead. Her half of the homestead would have a basis of $5,000 (one-half of the original cost basis of $10,000). When this half was sold for $55,000, the wife would realize a $50,000 long-term capital gain and would pay a maximum of $14,000 of income taxes (28% of $50,000).

If, on the other hand, the couple lived in a community property state like Washington, the income tax savings would be even greater. If the homestead was community property under Washington law, for example, the wife would get a step-up in basis in both halves of the homestead to $110,000. After her husband's death when she sold the homestead for $110,000 she would pay no income taxes! In contrast, in the prior example of the married couple in Alaska who owned the homestead that was not community property, the wife who sold the homestead after her husband died would pay $14,000 of income taxes. In this way the income tax laws favor spouses in community property states who own assets as community property over spouses in non-community property states like Alaska who as a general rule cannot own assets as community property.

Overview of HB 199

This bill will allow married Alaskans to execute a written agreement to recharacterize their assets as community property. Unlike other states, which have a community property form of ownership for married persons, Alaskans would have their assets treated as community property only to the extent they execute a written agreement and elect into a community property system under Alaska law. In contrast, community property states mandate the married couple's assets to be community property unless the spouses elect out.

The bill not only allows Alaskan couples to enter into an agreement to have some or all of their assets treated as community property, but it also permits married persons who do not reside in Alaska to have their assets treated as community property under Alaska law by executing an Alaskan Community Property Trust. Such a trust must have an Alaskan trustee. It is anticipated that many married persons who reside outside of Alaska will wish to label a portion, or all, of their assets as community property because they believe that it is a more appropriate method of owning their assets and they wish to obtain the income tax advantages which are available to community property upon the death of the first spouse.

Some believe that community property represents a more fair and rational system of sharing the ownership of property during marriage because it essentially treats the marriage like a partnership; as assets are earned during the marriage, they are treated as owned 50/50 by the two partners (the husband and wife). Others believe community property is not a fair or rational system. Regardless of one's beliefs, it seems appropriate to allow Alaskans, and residents of other states, the freedom to choose the arrangement that is most appropriate for them.

It should be emphasized that no asset would be labeled as community property under the bill. Rather, the bill merely authorizes married persons to execute a written agreement or trust in which they expressly elect to treat some or all of their assets as community property under Alaska law.

FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. CSHB 199 (JUD)

Revision Date:
Title: Community Property

Sponsor: Rep. Ryan and Therriault
Requestor: House Rules

Department: Commerce and Economic Development
BRU: Banking, Securities and Corporations
Component: Banking, Securities and Corporations

COMPONENT SERIAL NO.

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY02	FY 03	FY 04
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 General Fund						
1005 GF/Program Receipts						
1006 GF/Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $ 0.0

POSITIONS

FULL-TIME	
PART-TIME	
TEMPORARY	

ANALYSIS: (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director Willis F Kirkpatrick Phone: 465-2521
Division: Banking, Securities and Corporations Date: 1-25-98

Approved by Commissioner: Deborah B. Sedwick Date:
Agency: Commerce and Economic Development

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MEMORANDUM March 25, 1997

SUBJECT: Sectional Summary of HB 199, the "community property" bill (Work Order No. 20-LS0522\E)

TO: Representative Joe Ryan
Attn: David Pree

FROM: Theresa Bannister
Legislative Counsel

You have requested a sectional summary of the above-described bill. As a preliminary matter, note that a sectional summary of a bill should not be considered an authoritative interpretation of the bill. The descriptions of the sections necessarily contain some generalizations and simplifications. As a result, please keep in mind that the bill itself is the best statement of its contents.

Section 1. States that community property under the new chapter (AS 34.75) is not included in the augmented estate. "Augmented estate" is a term used in the state's Uniform Probate Code to refer to the pot of property from which a surviving spouse can elect to take a one-third share; the property in the estate is "augmented" by adding to it certain other property transferred to others by the decedent.

Section 2. Makes an amendment to AS 25.15.010 to show that its provisions are subject to the new community property chapter (AS 34.75).

Section 3. Makes an amendment to AS 25.15.020 to show that the section is subject to the new community property chapter (AS 34.75).

Section 4. Makes an amendment to AS 25.15.050 to show that the provisions of the section are subject to the new community property chapter (AS 34.75).

Section 5. Makes an amendment to AS 25.15.060 to show that the provisions of the section are subject to the new community property chapter (AS 34.75).

Section 6. Adds a subsection to AS 25.24.160 (dealing with court judgments in divorce actions). The new subsection directs the court to distribute the parties' property under AS 34.75 according to their community property agreement or community property trust

under AS 34.75, if they have one. Directs the court to award one-half of the value of the community property to each party, unless the parties have agreed otherwise in the community property agreement or trust.

Section 7. Amends AS 25.24.200(a) (relating to dissolution of marriages) to include community property under AS 34.75.

Section 8. Amends AS 25.24.310(b) (relating to the payment of attorney fees, costs, and other disbursements in a child custody, support, and visitation matters) to include community property in the property that can be used to pay for a minor's legal representation or for other services.

Section 9. Amends AS 34.15.110 to make its provisions subject to the section in the new community property chapter, AS 34.75, that addresses how spouses can hold property. (The citation should be corrected to read "AS 34.75.110" in both places.)

Section 10. makes an amendment to AS 34.15.130. States that the conclusion that persons are tenants in common if they have an undivided interest in real property is subject to the provisions of the section in the new chapter, AS 34.75, that addresses how spouses can hold property. (The citation should be corrected to read "AS 34.75.110.")

Section 11. Adds a new chapter related to the property of spouses.

AS 34.75.010. Requires spouses to act in good faith towards each other if the matter involves community property. Prohibits changing this obligation in a community property agreement or trust.

AS 34.75.020. Allows a community property agreement or trust to change this chapter's effect, except for certain listed provisions.

AS 34.75.030. Limits the classification of property as community property to what the spouses say in a community property agreement or trust, except where this chapter classifies property otherwise.

Establishes a presumption that the spouses' property acquired during marriage and after the determination date (see AS 34.75.900 for definition) is community property, if the spouses' community property agreement says that all their property acquired during marriage is community property.

Gives a spouse a one-half interest in community property.

States that if the community property agreement states that all property acquired during marriage is community property, the income on the property is community property.

States that even if community property is transferred to a trust, it still remains community property.

States that property is not community property if it is owned by a spouse at the time of the marriage but before the determination date (see AS 34.75.900 for definition). This occurs even if the spouses' community property agreement provides that all property acquired during marriage is community property. However, the community property agreement may expressly provide differently.

States that certain listed property is individual property if it is owned by a spouse at the time of the marriage but before the determination date (see AS 34.75.900 for definition). This occurs even if the spouses' community property agreement provides that all property acquired during marriage is community property. However, the community property agreement may expressly provide differently.

States that appreciation and income of property transferred to a community property trust are community property if the trust says they are.

States that community property held in a trust remains community property when distributed to the spouses.

States that this chapter doesn't change property classification and ownership rights for property acquired before or during marriage, except as otherwise provided in this chapter.

AS 34.75.040. Identifies what property one spouse may manage and control alone.

Requires spouses to act together when managing and controlling community property that is held in both of their names (unless held in the alternative--"or").

States that the trust terms determine the management and control rights of community property transferred to a trust.

States that management and control rights for community property don't determine the classification of the property and don't rebut the presumption in AS 34.75.030(b).

States that management and control rights to community property do not permit gifts, except as provided in AS 34.75.050.

States that management and control rights are not affected by this chapter if the property is acquired before the determination date (see AS 34.75.900 for definition). Makes an exception to the extent provided otherwise in a community property agreement or trust.

Allows a court to appoint a conservator or guardian to handle the management and control rights of a disabled spouse.

AS 34.75.050. Prohibits one spouse acting alone from giving to a third party community property that the spouse manages and that is over $1,000 (in one calendar year), or is a larger amount unless the amount is reasonable considering the economic conditions of the spouses.

Subjects a gift not allowed under (a) of this section to a court action allowed under (d) unless both spouses act jointly or the gift is ratified by the other spouse.

Considers that the spouses have acted together when one spouse makes a gift, if either of certain U.S. gift tax activities occur.

Allows one spouse to bring a court action against a spouse making a gift that doesn't satisfy (a), or against the recipient of the gift, or both. Requires the action to be begun within a certain time. Characterizes a recovery during marriage as community property. Limits a recovery after dissolution or death of one spouse to one-half of the value of the gift and makes this recovery individual property.

AS 34.75.060. Allows spouses living in this state to classify all or part of their property as community property by using a community property agreement.

Allows spouses, even if not living in this state, to classify all or part of their property as community property by transferring the property to a community property trust that states that the property is community property.

AS 34.75.070. Establishes a presumption that an obligation incurred by a spouse during marriage is incurred in the interest of the marriage or family.

Restricts the satisfaction of a duty of support owed to the other spouse or child of the marriage to community property and the spouses's non-community property.

Restricts the satisfaction of an obligation incurred by a spouse in the interest of the marriage or family to community property and the non-community property of the spouse.

Restricts the satisfaction of certain obligations attributable to obligations, acts, or omissions before marriage to the non-community property of the spouse and certain community property.

Restricts the satisfaction of certain other obligation incurred by a spouse during marriage to the spouse's non-community property and the spouse's interest in community property.

States that this chapter doesn't change the spouses' relationship with their creditors with regard to property or obligations existing before the determination date (see AS 34.75.900 for definition).

Makes binding on a creditor a writing signed by the creditor that reduces the creditor's rights under this section.

States that creditor rights are not affected by a community property agreement or trust, unless the creditor knows about the effect when the obligation to the creditor is incurred. Prohibits changing the effect of this subsection by a community property agreement or trust.

States that this chapter doesn't affect a property exemption available under another law.

Sec. 34.75.080. Protects persons who are bona fide purchasers (in general, good faith purchasers for value without notice of a problem or adverse condition) in their transactions with spouses. States that notice of a community property agreement or trust, a marriage, or a marriage termination doesn't change the purchaser's status as a bona fide purchaser. Provides that certain community property purchased from one spouse by a bona fide purchaser is purchased free of any claim of the other spouse; prohibits changing this provision in a community property agreement or trust.

Sec. 34.75.090. Establishes certain requirements for and features of community property agreements. An agreement must be in writing, be signed, and make some property community property. Consideration (each spouse receiving something, usually money) is not needed for the agreement to be effective.

States that the agreement may not adversely affect a child's right to support.

Identifies various items that the spouses may agree on in the agreement.

Provides for the amendment or revocation of the agreement.

Allows persons who are not yet married to enter into an agreement, but prevents the agreement from becoming effective until they are married.

Establishes when community property agreements are unenforceable.

Provides that a court is the entity that determines whether an agreement is unconscionable (grossly unfair to one spouse).

Sec. 34.75.100. Establishes certain requirements for and features of community property trusts. To be a trust, it must be signed and state that some of the property transferred to the trust is community property, and one trustee must meet the qualifications given under the

section. Consideration (each spouse receiving something, usually money) is not needed for the trust to be effective.

States that the trust may not adversely affect a child's right to support.

Lists various items that the spouses may agree on in the trust.

Provides for the amendment or revocation of the agreement.

Establishes when community property trusts are unenforceable.

Provides that a court is the entity that determines whether a trust is unconscionable (grossly unfair to one spouse).

Requires the trustee to maintain certain records.

Sec. 34.75.110. Establishes how spouses may hold their property. Includes some new methods, e.g. holding separately or together as community property or holding as "survivorship community property" (where surviving spouse receives the other spouse's community property interest automatically). Provides for holding property as individual property.

Sec. 34.75.120. Prevents the issuer of an insurance policy from being liable because it makes payments or takes other actions on the policy, unless the issuer actually knew that the payments or actions were inconsistent with a community property agreement or trust or certain adverse claims.

Establishes some rules for how to classify the ownership of life insurance policies and proceeds.

States that this section does not affect a creditor's interest in a policy (or its proceeds) that is transferred or made payable to the creditor as security for an obligation.

States that this section does not affect the ownership interest or proceeds of a policy unless a spouse is listed as an owner and community property is used to pay a premium on the policy.

Sec. 34.75.130. Provides that other property becomes community property if it is mixed with community property and if it can't be traced (or except as provided in AS 34.75.110).

Provides that under certain conditions the individual property of one spouse is changed to community property if the other spouse contributes effort, skill, activity, etc. to the separate property.

Sec. 34.75.140. Gives a spouse a claim against the other spouse for failing to act in good faith, if the failure damages the claimant's community property interest.

Allows a court to order an accounting of the spouses' property and obligations. Allows a court to make certain listed determinations about the spouses' property.

Allows a court to order the addition of a spouse's name to the title of community property held in the name of only one spouse, except for certain listed property.

Requires a spouse to bring a court action against the other spouse under (a) within three years.

Sec. 34.75.150. After the death of a spouse living in this state and under certain circumstances, treats as community property the property that can be traced to certain recoveries of the decedent for a loss of earning capacity.

Sec. 34.75.160. Directs that this chapter is to be applied and construed uniformly with the laws on this same subject in other states and to be applied and construed to achieve its general purpose.

Sec. 34.75.900. Defines the terms in the chapter.

Sec. 34.75.995. Gives the chapter the title "Alaska Community Property Act."

Section 12. Describes how a section in the new chapter changes an Alaska Rule of Evidence.

Section 13. States that the provision in this bill that amends court rules only takes effect if the section describing how it amends the rule receives the necessary super-majority vote.

Section 14. Gives the bill an immediate effective date.

If I may be of further assistance, please advise.

TLB:jdr
97-218.jdr

MEMORANDUM

TO: Representatives and Senators

FROM: Representative Joe Ryan

SUBJECT: "Community Property Bill"

DATE:

This memorandum provides an Executive Summary and a more detailed Overview of the Community Property bill. The bill is designed, among other things, to allow married Alaskans to obtain an income tax advantage available to residents of nine other states and to produce business in Alaska.

Executive Summary

Nine states of the United States provide for married persons to hold assets acquired during the marriage as community property. These states are Louisiana, Texas, New Mexico, Arizona, California, Nevada, Washington (state), Idaho and Wisconsin. Under community property rules, most assets acquired during marriage by the husband or by the wife are owned one-half by the husband and one-half by the wife. This rule applies automatically, subject to certain exceptions. However, the husband and wife may execute a written agreement to elect not to have their assets treated as community property. If they elect for their assets not to be treated as community property, each asset will belong to the spouse who acquires it and no part of it will be owned by the other spouse, as a general rule.

When a property owner dies, the inherent profit (e.g., capital gains) in his or her assets is forgiven for income tax purposes. This is referred to as the "income tax-free set-up in basis". This forgiveness of income tax liability applies only to the assets which the decedent owned at death. For example, if a husband and wife own property together, only one-half is treated as own by the spouse who dies first and the inherent profit (e.g., capital gains) is forgiven only with respect to that one-half. The capital gain is not forgiven in the half which was already own by the surviving spouse.

Even though community property is also treated as owned by one-half by the husband and one-half by the wife, the inherent profit (e.g., capital gains) in 100% of the community property asset is forgiven when the first spouse dies. This rule has been contained in the Internal Revenue Code for decades and is unlikely to be changed. It means that a person who owns assets with his or her spouse as community property has a major advantage upon the death of the first spouse to die over a married person who owns assets with his or her spouse but which are not community property.

One of the purposes of the bill is to allow married Alaskans to execute a written agreement to recharacterize their assets as community property. Unlike other states which have a community property form of ownership for married persons, Alaskans would have their assets treated as community property only to the extent they execute a written agreement and elect into a community property system under Alaska law. In the current community property states, the law mandates the married couple's assets to be community property unless the spouses elect out. Because the change of ownership to community

property can have extremely far reaching effects, it is appropriate to allow Alaskans to elect into the system if they wish to arrive the benefits of ownership of community property as well as to obtain the income tax advantage for community property when the first of them dies, but not to mandate the use of a community property system.

The bill not only allows Alaskan couples to enter into an agreement to have some or all of their assets treated as community property, but it also permits married persons who do not reside in Alaska to have their assets treated as community property under Alaska law by executing an Alaskan Community Property Trust. Such a trust must have an Alaskan trustee. It is anticipated that many married persons who reside outside of Alaska will wish to label a portion, or all, of their assets as community property because they believe that is a more appropriate method of owning their assets and they wish to obtain the income tax advantages which are available to community property upon the death of first spouse to die.

It should be emphasized that no asset would be label as community property under the bill. Rather, the bill merely authorizes married persons to execute a written agreement or trust in which they expressly elect to treat some or all of their assets as community property under Alaska law.

Detailed Overview

Some Background on Ownership of Property Between Married Persons. All jurisdictions provide special rules for the treatment of assets acquired or owned by individuals while they are married. Many countries throughout the World provide

"community property" treatment of assets acquired during marriage. Under a typical community property system, all assets acquired by a husband or wife during the marriage are treated as community property. (Assets brought to the marriage, as well as gifts and inheritance received during the marriage, are generally excluded from being treated as community property.)

Essentially, community property is treated as own one-half by the husband and one-half by the wife. Therefore, if the couple divorces, each receives one-half of the community assets. Under community property rules, the first spouse to die is permitted to dispose of his or her one-half interest in the property and, usually, the surviving spouse is not given any rights to the one-half which is dispose of upon the death of the first spouse to die. Rather, the survivor already owns one-half interest in the community assets.

Nine states in the United States used the community property system. These states were, as a general rule, ones originally colonized by the Spanish or the French. Spain and France had a community property system. Wisconsin, in 1984, adopted community property by enacting the Uniform Martial Property Act, a uniform law providing for community property treatment.

The other states of the United States use, in large measure, a system derived under English law. That law provided for no division of property upon divorce, although virtually all states, including Alaska, now allow the courts to reallocate assets between the spouses in the event of a divorce. Under English law, a type of temporary property interest (known as dower widows and courtesy for husbands) was granted to a surviving spouse.

Almost all states which used the English system, including Alaska, have modified that rule to provide for a minimum or elective share to be taken by a surviving spouse.

Spouses May Vary Rights By Contract. Not infrequently, individuals, prior to or after marriage will agree on a division or sharing of their assets different from the rules which would otherwise apply under local law. One of the reasons for that is that the couple may move. For example, a couple may reside in the state of Washington (a community property jurisdiction) at the beginning of their marriage but then move to another state (such as Alaska) which does not provide for community property. A couple may well decide that they want community property to apply whether or not they moved to a non-community property state, for example.

Essentially, a couple which does not live in a community property state can enter into a written contract to have their property owned as though it were community property in all respects. That would give them the sharing benefits of community property but it would **not** provide them with certain income tax advantages of community property which will be discussed later.

Taxes and Community Property. Community property has been very well favored under the Internal Revenue Code. Based upon a decision of the Supreme Court of the United States in the 1930's, the tax law must respect the fact that community property is own one-half by the husband and one-half for the wife. Prior to 1948, that meant that a married couple in a community property state would pay less income tax than a couple in a non-community property state because the couple in the community property state were able

to treat their income as being equally divided between them. Because income tax rates increase as income increases, the community property couple usually could have their income taxed at the lowest range of income tax rates. Also, before the allowance of the estate tax marital deduction, only one-half of the couple's community property was subject to estate tax when the first spouse died. However, individuals who resided in non-community property states had to pay tax on their entire assets because under local law those assets were treated as own entirely, and not just one-half, by the spouse dying first.

These advantages were regarded as so significant that after World War II several states adopted or had legislation pending to adopt a community property system for married couples in those states. In 1948, the Congress amended the Internal Revenue Code to provide, essentially, the same income tax treatment for income of a married couple in a non-community property state as that provided for a couple in a community property state. In addition, the Congress allowed a marital deduction equal to one-half of the estate of a spouse to die for non-community property assets. That, in effect, put a married decedent in a non-community property state on the same footing, for estate tax purposes as a married person who died with community property. (Today the marital deduction is not limited to one-half of the estate.)

Major Remaining Income Tax Advantage for Community Property. While there continues to be some modest other advantages under the tax law for community property, one major difference remains. That difference relates to the income tax basis of inherited property.

Under Section 1014(a) of the Internal Revenue Code, the income tax basis of an inherited asset is equal to its estate tax value, as a general rule. Because property tends to appreciate over time, the effect of this section is to forgive the inherent profit (such as capital gains) in the asset when the owner of the property dies. For example, an individual buys Microsoft stock when it is worth $20 per share. She dies when it is worth $100 per share. If she had sold during her lifetime, she would have had to pay capital gains tax on the $80 profit on each share sold. However, if she dies when the stock is worth $100, her heirs will measure their gain from $100. The $80 profit is entirely forgiven for income tax purposes.

This automatic change in income tax basis upon death only applies to assets includable in the estate of an individual. Hence, when a married person dies, only the assets includable in the his or her estate are entitled to the change in income tax basis treatment. The Internal Revenue Code provides that only one-half of an asset jointly owned by husband and wife is includable in the estate of the first of them to die. However, if the asset were community property the income tax basis in the **entire** asset changes to estate tax value when the first of them dies.

Advantages and Disadvantages of Community Property. Some believe that community property represents a more fair and rational system of sharing the ownership or property during marriage because it essentially treats the marriage like a partnership: as assets are earned during the marriage, they are treated as owned 50/50 by the two partners (the husband and wife). Others, believe community property is not a fair or rational system. In any case, whether the couple resides in a community property state or non-community

property state, they may, by executing a written contract, choose to treat their property as though it is not community property or to provide for a treatment which is identical to community property. However, the favorable change in income tax basis under the Internal Revenue Code is permitted only for assets which are treated as community property only if the property "represents ... community property ... under the community property laws of any State...." Internal Revenue Code Section 1014(b)(6). Hence, merely providing by a written contract for assets to be treated in a way similar to community property will not cause them to be treated as community property under the Internal Revenue Code because they are not community property under state law . By allowing Alaskan couples to treat their assets as community property under Alaska law, the assets should be treated as community property for purposes of the Internal Revenue Code. This, in essence, will allow married Alaskans to obtain the same benefits which are available to couples in the current nine community property states. However, no couples' assets would be reclassified as community property under Alaska law except to the extent the couple enters into a written agreement providing for such treatment under Alaska law.

What the Bill Would and Would Not Do. Community property laws of the states which have them apply automatically to the assets of a married couple unless and except to the extent that the couple elects out of community property treatment. Whether one believes that community property represents a better or worst form of ownership, a change to a community property system would be farreaching. Therefore, under the bill, the nature of assets owned by an Alaskan couple would not be changed unless and except to the

extent they enter into a written agreement (or trust) in which they label certain, or all, of their assets as community property. Therefore, a couple must elect into community property in order for the law to have any impact on their assets. Therefore, the bill will have no impact on a couple unless they voluntarily enter into a written agreement in which they expressly label some or all of their assets as community property.

A married couple may enter into a community property agreement if they are both Alaskans. If neither spouse, or only one of the spouses is an Alaskan, the couple may choose to classify certain of their assets as community property by transferring them to an Alaska Community Property Trust.

More Information. The Bill is derived from the Uniform Community Property Act. Wisconsin adopted that act in 1984. However, under the Uniform Community Property Act, all assets of the couple are automatically relabelled as community property (subject to certain exceptions) merely by reason of the enactment of the law. Therefore, couples who do not wish for their assets treated as community property have to elect out by written agreement. Therefore, if one spouse does not wish to change the nature of their property from community property to another form, he or she can prevent the reclassification from occurring. Under the bill, the opposite would occur. The enactment of the bill would have no impact on the treatment of property owned by a husband and/or wife. Only if the husband and wife enter into an agreement (or trust) after the enactment of the bill to treat part of their assets as community property would a change in the nature of their assets occur.

In accordance with the Uniform Community Property Bill, its provision require that the spouses act in good faith toward each other with respect their community asset. The bill also prevents the use of the community property agreement or the community property trust to interfere or to hinder the rights of the creditor or to reduce the obligation of child support of a parent. The bill provides certain rules for the treatment of community property. For example, it provides that one spouse alone cannot make a gift to a third party of community property unless the value of the community property given does not exceed more than $1000 in a year or larger amount if, when made, the gift is reasonable in the amount considering the economic position of the spouses. (This provision is derived from the Uniform Community Property Act.) Also, community property would automatically be divided 50/50 upon divorce. Courts could not reallocate the assets in another way. However, all of these rules, subject to the safeguards for creditors, child support payments and acting in good faith, may be modified by the couple. Because the couple will be able to label their assets as community property only by a written agreement, they will have an opportunity to vary the rules, which otherwise are provided under the bill, to the extent they desire, in their community property agreement or community property trust. Therefore, even the rules which would be provided under the bill will not apply unless the couple executes the community property agreement or community property trust and they do not provide in their agreement or trust for alternative or different treatment than that provided under the bill.

C. Trustee Provisions. The following trustee and trustee power provisions should be included, at minimum:

> This Trust shall at all times have as Trustee or at least one Co-Trustee a person, bank or trust company which is a "qualified person" under Alaska Statutes. The duties of such Trustee or Co-Trustee shall at all times include, at minimum, maintaining records for the Trust on an exclusive or nonexclusive basis, preparing or arranging for the preparation of, on an exclusive or nonexclusive basis, the Trust's annual income tax return, and part or all of the administration (including physically maintaining trust records) occurs in Alaska.
>
> The Trustee shall at all times have some or all of the Trust assets, within the meaning of Alaska Statutes Section 13.36.055(c)(1), deposited in Alaska.

C. Spendthrift Provision. The usual spendthrift provision should be modified to make reference to the interest of the grantor and to Alaska law, as follows:

> No interest in the income or principal of any portion of the Trust property shall be subject to any form of voluntary or involuntary transfer, alienation or hypothecation by any beneficiary, nor shall any such interest or property otherwise be or become subject to the claims or liens of any person until such time as the property has actually been distributed in accordance with the terms of this instrument. This prohibition is intended to prevent all voluntary and involuntary dispositions by any beneficiary, specifically including the Grantor, of any part of any interest with respect to a portion or all of the trust property in any manner, as provided for under Alaska Statutes § 34.40.110.

D. Controlling Law. Finally, the following should be included:

> This Trust shall be controlled in all respects by the laws of the State of Alaska.

If a primary purpose of the trust is asset protection, the wise drafter should also include a typical flee clause, directing transfer of the trust situs and controlling law to an offshore jurisdiction if attachment by creditors looms.

VI. Alaska Family Limited Partnerships and LLC's

Alaska has also modified its statutes in 1997 relating to limited partnerships and limited liability companies to make the state a more desirable location for forming family limited partnerships and LLC's. Internal Revenue Code Section 2704(b) can restrict valuation discounts that are based upon provisions in governing documents that are more restrictive than applicable under state law, so choosing a state with favorable law is vital for maximizing valuation discounts. Alaska's changes and other existing features include:

a. No Limited Partner "Put" Right. In the past few years, many states, including Florida, Georgia, Delaware, Nevada and Colorado, have eliminated the six-month limited partner "put" right found in the Revised Uniform Limited Partnership Act ("RULPA"). Alaska has followed suit, and current AS

32.11.250 provides that a Limited Partner has no withdrawal right unless the partnership agreement provides for one.

b. Unlimited Life. Limited partnerships and LLC's are perpetual as long as there is at least one partner/member.

c. Court Ordered Liquidation. Under the laws of most states, a court can order the liquidation of a partnership or LLC for "any equitable reason." AS 32.11.380 provides that a court can only order the liquidation of a limited partnership or LLC only if it is impossible for the entity to continue to operate.

d. Amendment of Partnership Agreement. A limited partnership or LLC agreement may be amended only with unanimous consent of all partners or members.

Alaska does not impose any income or intangibles tax on limited partnerships or limited liability companies. Filing fees are $150.00 for a limited partnership or for a limited liability company, and there are no annual report fees. Corporate Information Services (phone: 360-754-9333, fax: 360-754-5781) charges $90.00 to form the entity, and a $165.00 annual Registered Agent fee.

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The Alaska Asset Protection Trust

Summary

On April 2, 1997, Alaska began competing for business with such offshore jurisdictions as Barbados, Belize, the Cayman Islands, the Channel Islands, the Cook Islands, and Nevis. The state legislature enacted a law authorizing the Alaska Asset Protection Trust.[1]

Advantages. The intended advantage of this trust is shelter from certain creditor claims. Shelter would be most likely to occur against future creditor claims, due to Alaska's retention of the fraudulent conveyance doctrine.[2] A settlor can transfer property into this type of trust, protect the property from these types of claims, and retain a degree of benefit and control over trust property.

Limitations. There are two basic limitations of this trust: (1) at least four years must pass after funding the trust before the statute of limitations extinguishes fraudulent conveyance claims, and (2) the settlor must surrender a significant degree of control over trust assets.

Surrender of control occurs in several ways: (1) the settlor must not retain a power to terminate or revoke the trust, (2) the settlor cannot dictate distributions from the trust, (3) the settlor cannot serve as trustee, (4) the settlor cannot be the only beneficiary, and (5) the settlor's beneficial interest can be only that of a discretionary beneficiary. It is up to the trustee—someone other than the settlor—to decide whether the settlor should receive any distribution from the trust.

Indirect Retention of Control. The settlor might retain some measure of indirect control over trust assets. Two optional features can be authorized in the trust instrument: (1) the settlor's power to veto distributions and (2) the settlor's special testamentary power of appointment over trust assets.

Dynastic Estate Planning. The Alaska Asset Protection Trust could also facilitate estate plans intended to cover multiple generations of beneficiaries.

Powers That Might Be Retained by the Settlor

Veto Power. The first optional feature is the settlor's power to forbid discretionary distributions. This is not a power to prescribe distributions but rather to prevent them if they do not meet with the settlor's approval. AS 34.40.110(b)(2).

Testamentary Special Power of Appointment. Second, the trust instrument can reserve for the settlor a testamentary power to appoint trust assets to persons other than the settlor's creditors or estate. *Id.* Power that the settlor surrendered during life—the affirmative power to dictate distributions—would return to the settlor upon death.

In This Issue

Distributions by Consent. These two optional features might lead to distributions that were indirectly prompted by the settlor. The trustee—probably a financial institution—would receive some sort of consent from the beneficiaries to distribution of trust assets to whichever beneficiaries were specified. The settlor might be the only beneficiary specified to receive a distribution.

Friendly Trustee. As a legal matter, the trustee would have power to disregard such promptings. In fact, it would be prudent for the trust instrument not even to mention such procedures. As a practical matter, however, the trustee would have good reason to act as a so-called "friendly trustee" and cooperate with any reasonable suggestion from the beneficiaries. As further assurance of harmony between trustee and beneficiaries, there could be a "trust protector" provision for removing and replacing an uncooperative trustee.

Cooperative Beneficiaries. Also as a legal matter, some beneficiaries could oppose a request for distribution that was initiated by the settlor for the settlor's benefit. In practice, however, beneficiaries would be persons whom the settlor had selected and whom would have a strong incentive to cooperate with the settlor. The incentive would stem from the settlor's retained powers to veto distributions and to appoint ultimate distributions by means of a will.

This arrangement may work to protect the settlor's assets from creditors. It may also help the settlor to retain some indirect benefit and control over those assets. The separate issue of estate tax consequences is discussed later in this article.

How This Differs from the Law of Most States

The Predominant Rule. The predominant rule of law throughout the United States is that a transfer into trust is void or voidable against the settlor's creditors, if the settlor is entitled to distributions from the trust or is even eligible for discretionary distributions. This is the rule of the Restatement (Second) of Trusts § 156(2) (1959). It appears to be the law of Oregon.

Until this year, the only recent departures from this rule were a couple of tax decisions of uncertain application from Maryland and Indiana. *In re Uhl's Estate*, 241 F2d 867 (7th Cir 1957); *Estate of German v. United States*, 85-1 USTC (CCH) ¶ 13,610 (Cl Ct 1985). Americans preferred to entrust billions of dollars to locations outside of the United States, in jurisdictions offering clear statutory protection.

The Alaska Rule. Now Alaska offers statutory protection. A settlor can make a lifetime transfer into an Alaska Asset Protection Trust, cause trust assets to be protected from creditor claims, and remain eligible for discretionary distributions from the trust.

In any state, a distinction might be drawn between laws of substantive liability and laws of exemption. The new Alaska statute tends toward the latter concept. For example, the statute does not alter liability for the tort of professional negligence. On the other hand, the statute does affect which assets might be seized to satisfy a judgment for malpractice. In this sense, the Alaska law resembles a debtor exemption statute, such as a homestead law.

Will It Work?

The burning issue is whether an Alaska Asset Protection Trust could be subjected to the debtor/creditor laws of a state that followed the predominant rule described above. If that happened, asset protection would end. This conflicts-of-law issue could be litigated in a federal forum such as a U.S. Bankruptcy Court. It could also arise from an effort to enforce a judgment from outside of Alaska in the Alaska court system, under the full faith and credit clause of the U.S. Constitution. It might even occur in litigation originating in Alaska, although this seems less likely.

The new Alaska statute is untested. Court challenges could result in rulings that cut both ways. Opposite outcomes are suggested by two conflicting lines of authority.

The Situs Rule. Supporting Alaska Asset Protection Trusts would be a line of authority led by the Restatement (Second) Conflicts of Laws § 273 (1971). According to this view, the situs of a trust as decreed in its governing instrument determines the jurisdiction whose debtor/creditor laws apply to it.[3] *In re Remington*, 14 BR 496 (Bankr D NJ 1981), for example, involved a trust created under Pennsylvania law, a New Jersey beneficiary, a New Jersey creditor, and a liability arising in New Jersey. The court applied Pennsylvania law because the trust instrument provided that the trust was situated and governed by the laws of that state. In sum, the "situs rule" would allow an Alaska Asset Protection Trust to be covered by Alaska's debtor/creditor laws.

One reason that a court might balk at applying the situs rule is that a creditor will never be privy to a trust agreement's provision regarding governing law. It might seem unfair for a creditor's rights to be restricted by an agreement to which the creditor was not a party. On the other hand, the "rights" being restricted would not involve substantive liability, but only exemption. Furthermore, the situs rule would still leave the creditor with the remedies of Alaska's fraudulent conveyance statute, which is comparable to laws of other states. Where a debtor acted to defraud a creditor, the creditor would continue to have four years to make a claim against trust assets.

The Significant Relationship Rule. An opposite line of authority would be much less receptive to Alaska Asset Protection Trusts. These cases hold that the jurisdiction with the most "significant relationship" to a trust is the one whose debtor/creditor laws govern that trust. *In re Portnoy*, 201 BR 685 (SDNY 1996); *In re Brown*, 4 Ak Br Rpt 279 (Bankr D Ala 1995). Under this rule, a trust provision claiming coverage by Alaska law would not necessarily be enforced. If the trust bore a significant relationship to some state other than Alaska, then Alaska's asset protection laws might not shield the trust's assets from creditors.

The significant relationship rule seems intended, however, for unusual situations. Decisions adopting this rule began with fact patterns of gross bad faith, liability arising outside of the state where the trust was situated, and a potentially inequitable result. The court's apparent response was to look for a significant relationship between the trust and a jurisdiction whose laws might afford the creditor a decent remedy.

This author believes that both of the foregoing rules will be applied in future cases. Risk factors that could imperil an Alaska Asset Protection Trust would include (1) gross bad faith by the settlor, (2) liability arising outside of Alaska, (3) trust administration occurring outside of Alaska, and (4) trust assets, particularly real estate, located outside of Alaska. On the other hand, a trust that was not heavily burdened by these characteristics would stand a good chance of surviving a court challenge.

Tax Issues

Overlaying the Alaska Asset Protection Trust are various gift, estate, and generation-skipping transfer tax issues that are common to all estate planning. A few of those issues are discussed below.

Estate Tax Exemption. To make use of the lifetime exemption (and associated unified credit) against the federal estate tax, Alaska attorneys have developed two general versions of the Alaska Asset Protection Trust.

The "incomplete gift" version might be attractive to clients who care more about influencing distributions than removing post-transfer appreciation from their estates. In this version, powers retained by the settlor are maximized, including both of the optional powers discussed earlier in this article. The results are (1) inclusion of trust assets in the settlor's gross estate and (2) preservation of the estate tax exemption to shelter some or all of those assets.

The "completed gift" version, on the other hand, might be attractive to clients who care more about estate tax minimization than retained ability to influence distributions. In this version, powers retained by the settlor are minimized. The optional retained powers discussed above are entirely omitted. The intended results are (1) removal of trust assets (and their subsequent appreciation) from the settlor's gross estate and (2) depletion of the settlor's estate tax exemption.

There is controversy over whether it would always be possible to make a completed gift into this type of trust. The Internal Revenue Service has stated that a completed gift does occur, if a settlor transfers assets into a trust, surrenders all dominion, control, and beneficial interest except that of a discretionary beneficiary, and the assets become unavailable for satisfaction of creditor claims against the settlor. Rev Rul 76-103, 1976-1 CB 293. But an Alaska Asset Protection Trust might not protect against all creditor claims, for reasons previously discussed. So, there might not be assurance, at time of funding, that a transfer into trust succeeded in removing assets from the settlor's gross estate.

One response to this uncertainty would be to use only the incomplete gift version and abandon any hope of removing post-transfer growth from the settlor's gross estate. A different response might be to use both versions and create two trusts. One trust would attempt to remove assets from the gross estate with an inter vivos completed gift. It would be funded to the extent of the settlor's unexhausted exemption. The other trust could maximize the settlor's retained powers with an incomplete gift. Both trusts could obtain asset protection.

Assuming that a completed gift was accomplished, it might be dangerous for that transfer to be followed by a regular stream of distributions to the settlor. This could cause inference of a de facto agreement to that effect, under IRC § 2036(a)(1), with resultant inclusion of trust assets in the settlor's gross estate. On the other hand, sporadic distributions to the settlor would not tend to trigger such an inference. *See, e.g., Skinner's Estate v. United States*, 197 F Supp 726, (ED Pa 1961), *aff'd* 316 F2d 517 (3d Cir 1963).

Annual Gift Tax Exclusion. A second issue is whether transfers into an asset protection trust can be sheltered by the annual $10,000 gift tax exclusion.

This would be unnecessary if the incomplete gift approach were followed. Such a transfer would not deplete the lifetime estate tax exemption.

On the other hand, the annual gift tax exclusion would be useful as a setoff against a completed gift transfer. There would be a potential obstacle — the "present interest rule." Subject to a few exceptions, transfers into trust constitute gifts of future interests, which do not qualify for the annual gift tax exclusion. This problem can probably be averted or minimized through the use of "Crummey" powers of withdrawal. If beneficiaries other than the transferor were furnished with Crummey withdrawal powers for an appropriate period of time after transfers into trust, then those transfers would probably be sheltered by the $10,000 annual gift tax exclusion.

Nonresidents of Alaska

Settlors and Beneficiaries. Oregon estate planners might wonder whether nonresidents of Alaska can enjoy the benefits of an Alaska Asset Protection Trust. The answer is yes. The statute does not impose any residency (or nationality) requirement on settlors or beneficiaries of such trusts. Only trustees need to be Alaskan.

Trustees. Oregon trust companies might wonder whether they could participate in the administration of such trusts. The answer is yes, with some qualifications.

To qualify under Alaska's asset protection statute, a trust must satisfy the following four requirements: (1) the trustee must be either an individual who is a resident of Alaska or a trust company or bank with trust powers with principal place of business in Alaska, (2) some or all trust assets must be deposited in Alaska, (3) the Alaska trustee must be empowered to maintain trust records in Alaska and to file tax returns for the trust, and (4) "part or all of the administration" must occur in Alaska. AS 13.36.035(c).

The phrase "part or all" suggests that some fractional involvement by non-Alaska fiduciaries would be permissible. In response to this language, Alaska trust companies have already begun developing procedures for sharing administration with non-Alaska fiduciaries. Their brochures and forms suggest a subcontractor relationship. Investments, distributions, and customer service interaction might be handled by a subcontractor located outside of Alaska, wherever the settlor or other beneficiaries resided. Meanwhile, activities occurring within Alaska would include trust accounting, tax compliance, and maintenance of at least one fund, which might be used to cover expenses of trust administration.

A note of caution should be raised. Use of a non-Alaska

fiduciary is one of the risk factors identified earlier in this article. The more non-Alaskan the trust, the more vulnerable the trust becomes to the debtor/creditor laws of states other than Alaska.

Shifting to Other Jurisdictions

There could be several reasons for wanting to shift an Alaska Asset Protection Trust to a different location. For example, other states might enact asset protection legislation. Delaware already appears to have done so. Del Code Ann 12 § 3501, *et seq*. Under such circumstances, it would be helpful if a trust originating in Alaska could be moved elsewhere in the United States.

An opposite set of facts might also provide impetus for removing a trust from Alaska. If courts broadly embraced conflict of laws doctrines such as the significant relationship rule discussed above, then it might be desirable to move a trust to an offshore location such as the Cook Islands.

One of the trust companies in Alaska suggests that trust instruments include a "trust protector provision" to remove the trust from Alaska. It would be prudent for someone other than the settlor to hold the removal power, since removal would in some ways resemble a termination and reconstitution of the trust. Termination is one of the powers a settlor is not allowed to retain.

Client Profile

Wealthy Clients with Future Liabilities. Alaska Asset Protection Trusts could be attractive to clients with large estates and the potential for large future claims.

A stereotypical client might be a wealthy professional who wanted to retire in a few years with the knowledge that a large pool of assets, beyond funds in IRAs and qualified retirement plans, was protected from malpractice claims. This client could establish the trust, fund it, remain individually solvent and continue to work for at least four more years. At the end of that time, the client could look forward to retiring with access to funds that were exempt from creditor claims.

This type of trust would be less useful to clients who were already being pursued by creditors. The Alaska statute provides that creditors can bring an action for fraudulent conveyance for four years after the settlor funds the trust. Furthermore, this type of trust is unavailable to settlors who are 30 days or more in default of a child support obligation. AS 34.40.110(b)(4).

Dynasty Trusts. A related profile would be clients interested in establishing so-called "dynasty trusts." These multigenerational trusts are limited in most states by the Rule Against Perpetuities. The new Alaska law repeals this doctrine's applicability to discretionary trusts situated in Alaska. AS 34.27.050(a)(3). An Alaska Dynasty Trust can therefore operate in perpetuity.

Alaska is not the only state to have embraced dynasty trusts. Delaware, Idaho, Illinois, South Dakota, and Wisconsin have passed similar laws repealing the Rule Against Perpetuities. Alaska, however, offers the combined advantages of perpetual trusts, asset protection, and no state income tax. These advantages could magnify the initial size and subsequent growth of an Alaska Dynasty Trust.

First of all, the trust could compound from a base that included both the initial transfer and any appreciation or income that occurred between the time of transfer and the settlor's death. This would result from the settlor funding the trust with an inter vivos completed gift equal to the settlor's estate tax exemption or GST exemption. (The earlier discussion of Rev Rul 76-103 explains how asset protection might make a completed gift and resultant leverage of one or both exemptions possible.) Second, corpus would be enhanced to the extent that the trust avoided losing assets to creditor claims. Finally, the trust could grow faster by not losing revenue to a state income tax. Over several generations, an Alaska Dynasty Trust might compound to a size significantly larger than if it had operated under traditional trust, debtor/creditor, and tax laws.

Conclusion

The Alaska Asset Protection Trust offers clients an opportunity to shield wealth from future claims while retaining some degree of benefit and control. It might also enhance the funding and growth of a related estate planning vehicle, the Alaska Dynasty Trust.

Bob Casey

End Notes

1. SCS CSHB 101(JUD) of the Alaska Legislature became effective on April 2, 1997. Its provisions are distributed throughout the Alaska Statutes 13.12, 13.36, 34.27, and 34.40. The statutes do not use upper- and lowercase spellings to refer to qualifying trusts; this article does so for purposes of readability.

2. Exceptions cutting both ways could occasionally occur. For example, an Alaska Asset Protection Trust might also protect against current creditors (those whose claims arose before the trust was funded), if they (1) failed to commence legal action within four years of the date of funding or (2) were unable to prove that the settlor's insolvency was caused by the transfer into trust. On the other hand, an Alaska Asset Protection Trust would not protect against any creditor who commenced legal action within four years of funding and was able to prove the settlor's actual intent to hinder, delay, or defraud. AS 34.40.010, *et seq*.

3. If the trust property consists of real estate, however, the law of the situs of the real estate will govern. Restatement (Second) Conflicts of Laws § 280.

Questions, Comments, or Suggestions About This Newsletter?

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