Impact of Foreign Community Property Laws on U.S. Estate Tax Planning

By
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1. Community Property Basics

Community property is not defined in the Internal Revenue Code for estate and gift tax purposes. In general, "community property" is property, not otherwise classified as separate property, held by a married couple domiciled in a community property jurisdiction which provides that each spouse has a "vested" undivided one-half ownership interest in the couple's community property which, upon dissolution by death or divorce, entitles each spouse or the surviving spouse the right to partition the community property and receive one-half thereof.[2]

Section 2033 provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." For federal estate tax purposes, only 50% of the value of community property is included in the gross estate of the first spouse to die. However, Section 1014(b)(6) provides that the surviving spouse's community property is entitled to a step up in basis, thereby allowing a 100% step up in basis of community property assets on the death of the first spouse.

Today there are nine states within the United States that have community property regimes: California, Texas, Washington, Idaho, New Mexico, Arizona, Louisiana, Nevada and Wisconsin. Alaska permits its residents to elect into a community property regime.

2. International Community Property Regimes

In general, "common law" countries such as England, Canada or Australia do not have any form of community property regimes. On the other hand, in "civil law" countries community property regimes are quite common. For example, Brazil, Chile, China, Costa Rica, Denmark, France, Italy, Mexico, Netherlands, Philippines, Russia, South Africa, Spain, Sweden, Switzerland, and Ukraine have some form of community property regime.[3]

International community property regimes can broadly be categorized into three types:

(i) Universal community that applies to all the couples' assets, both those brought into the marriage and those acquired thereafter.

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[2] *See generally* Poe v. Seaborn, 282 U.S. 101 (1930).

[3] *See* Michael W. Galligan, *International Estate Planning for U.S. Citizens: An Integrated Approach*, Estate Planning Journal, Mar/April 1999.

(ii) A more common community property regime is community of after acquired property.[4] Most (but not all) Latin American jurisdictions tend to have some form of community that applies only to assets that are acquired following the marriage. Argentina, Brazil, Colombia and Venezuela are examples of this. In the absence of a couple making an election for another regime to apply by way of a notarial instrument entered prior to the marriage, this regime will cause any assets acquired by either party (and income from passive investments produced by either party) to be treated as jointly owned. Exceptions tend to be gifts and inheritances received by a spouse during the marriage, although care must be taken given that income produced from such gifts or inheritances may (depending on the country) be jointly owned.

(iii) Community property that crystallizes on the dissolution of the marriage. Several Central American countries, including Costa Rica, do not treat assets as jointly owned until a death or divorce dissolves the marriage. As such, each spouse may be free to transfer assets as he or she pleases, free from the other's property rights. Only at the end of the marriage, will the spouse's communal interest in property owned at the date of death of the first spouse arise.

Not all international community property regimes will be respected as a community property regime for U.S. federal tax purposes. When dealing with a foreign community property system, U.S. federal case law has first determined whether the foreign jurisdiction gives each spouse a "vested interest" in the community income or property.[5] For such purpose, the U.S. courts generally have compared the foreign community property laws with the laws of those community property states in the United States.[6] In general, each spouse is considered to have a "vested interest" in a community property jurisdiction if each spouse is considered the owner of an undivided one-half interest in the couple's community property which, upon dissolution by death or divorce, entitles each spouse or the surviving spouse the right to partition the community property and receive one-half thereof.[7]

In *Poe v. Seaborn*[8], the U.S. Supreme Court proscribed the broad attributes of a community property system. The U.S. Tax Court interpreted these broad attributes to mean those which provide protection of the interest of each spouse in the community property: "(1) by legally assuring its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse, and (2) by limiting the managing

[4] This is the current default regime in France.

[5] *See* Angerhofer v. Comm'r, 87 T.C. 814, 826 (1986); Westerdahl v. Comm'r, 82 T.C. 83, 87 (1984). The Internal Revenue Manual identifies the following foreign countries as being community property countries: Belgium, Brazil, Colombia, Dominican Republic, Mexico, France, Guatemala, Philippines, Montenegro, Netherlands, Portugal, Spain, Sweden, and Venezuela. Internal Revenue Manual, § 21.8.1.15.

[6] *See Angerhofer*, 87 T.C. at 826 (comparing German law); *Westerdahl*, 82 T.C. at 87 (comparing Swedish law).

[7] *See generally* Poe v. Seaborn, 282 U.S. 101 (1930).

[8] Poe v. Seaborn, 282 U.S. 101 (1930).

spouse's powers of management and control so that detriment to the non-managing spouse from fraud or mismanagement will be minimized."[9]

Generally speaking most civil law countries only permit spouses to make a one-time election out of a community property regime at the time of or prior to the marriage. As a general rule, post-nups (i.e., agreements to change the property regime during the marriage) are not permitted, sometimes making planning difficult. It should be noted that U.S. style pre- or post-nups will not generally be recognized in civil law countries. Generally, marital property agreements must be drawn up and executed before a local notary.

3. International Marriages / Migrating Couples / Conflict of Laws

Marital property rights are generally determined by the laws of the marital domicile. Determining marital domicile by itself is not an easy task, particularly when a couple married under a foreign law or changed their marital domicile during marriage. This is because complex conflict of laws issues can arise. The starting point should be reviewing the laws of the jurisdiction where the couple celebrated their marriage. If the couple never resided in the place of celebration of their marriage, or subsequently changed their marital domicile, the marital domicile at the date of death should also be considered. In most cases the marital domicile will be either the place of celebration, the laws of the first matrimonial domicile, the laws of the last matrimonial domicile or the domicile of the common nationality.

Is it possible that a married couple's property rights can be altered by a change of domicile? In the international front, there are two competing doctrines, those of "immutability" and "mutability."[10] According to the doctrine of immutability, the parties' property acquired after the change of domicile is subject to the regime which was established before the change of domicile. Under the doctrine of mutability, rights to property acquired after the change are regulated by the law of the parties' domicile at the date of its acquisition. In some countries, a part-mutability/part-immutability concept is followed. For example, the majority view in the United States is that if a husband and wife move from a common law state to a community property state, or vice versa, the character of property acquired by them before the move (or property substituted for such property) is not affected.[11] But the laws of the new marital domicile will determine the status of property acquired after the move.

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[9] *See Angerhofer*, 87 T.C. at 826 (comparing German law); *Westerdahl*, 82 T.C. at 91 (comparing Swedish law).

[10] *See* Jeffrey A. Schoenblum, "Theories of Marital Property on the International Stage", A GUIDE TO INTERNATIONAL ESTATE PLANNING, § 10.24 (ABA Section of RPPTL)(2000).

[11] Barbara R. Hauser, *Community Property Regimes and Cross-Border Tax Consequences*, Cadwalader, Wickersham & Taft (New York and London and University of Minnesota Law School (2002).

Property rights may also depend on the situs of the assets. In the United States, the character of real property as community or separate is governed by the laws of the state where the property is located.[12] Thus, the general rule in the United States is that a change in the marital domicile does not affect the status of real property.[13] The character of personal property is governed by the law of the marital domicile when acquired.[14] Thus, personal property acquired by either spouse while domiciled in a common law state isn't converted from separate property into community property as a result of a subsequent change of the marital domicile to a community property state, even though the property is taken into the community property state.

In addition to real property, the law governing certain types of personal property may control its disposition. For instance, in Florida, the disposition of a "deposit account" located in Florida shall be governed by the laws of Florida regardless of the laws of the domicile of the account holder.[15] Thus, is it possible to convert community property

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[12] In *Quintana v. Quintana*, 195 So. 2d 577 (Fla. Dist. Ct. App. 1967) the Florida court relied on Restatement, Conflict of Laws. Under the Restatement Second, Conflict of Laws, "[t]he effect of marriage upon an interest in land acquired by either of the spouses during coverture is determined by the law that would be applied by the courts of the situs." Restatement 2d, Conflict of Laws § 234(1). Further, the local courts "would usually hold that any marital property interests which the spouses had in the funds or other property exchanged for the land have been transferred to the land itself." Restatement 2d, Conflict of Laws § 234 comment a.

See also Fla. Stat. § 732.225 (providing that the Florida Uniform Disposition of Community Property Rights at Death Act does not prevent married persons from severing or altering their interests in property to which these sections apply. The reinvestment of any property to which these sections apply in real property located in this state which is or becomes homestead property creates a conclusive presumption that the spouses have agreed to terminate the community property attribute of the property reinvested).

[13] *See id.*

[14] *See Quintana*, 195 So. 2d at 580. The "[i]nterests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicile of the parties when the movables are acquired." *Id*. at 579 (citing to Restatement, Conflict of Laws § 290 (1934)). However, if the movables were acquired with funds that are traceable to when the spouses where domiciled in a community property jurisdiction then such movables could be a community asset. *Id*. at 580.

[15] Under Florida law:

> The law of this state, *excluding its law regarding comity and conflict of laws*, governs all aspects, including without limitation the validity and effect, of any deposit account in a branch or office in this state of a deposit or lending institution, including a deposit account otherwise covered by s. 671.105(1), *regardless of the citizenship, residence, location, or domicile of any other party* to the contract or agreement governing such deposit account, and regardless of any provision of any law of the jurisdiction of the residence, location, or domicile of such other party, whether or not such deposit account bears any other relation to this state . . . .

Fla. Stat. § 655.55(1)(emphasis added). A "deposit account" includes:

> any deposit or account in one or more names including, without limitation, any certificate of deposit, time deposit, credit balance, checking account, interest-bearing account, non-interest-bearing account, individual retirement account (IRA), money market account, NOW account, transaction account, savings account, passbook account, joint account, convenience account, escrow account, trust account, custodial account, fiduciary account, deposit in trust, or Totten trust account.

Fla. Stat. § 655.55(3)(b).

funds to common law property by simply transferring to a Florida bank account? The answer is not clear in light of the Florida Uniform Disposition of Community Property Rights at Death Act[16] which provides a rebuttable presumption that personal property acquired while domiciled in a community property jurisdiction, or otherwise traceable to community property funds, is community property.[17]

4. Federal Estate Tax Analysis: *Estate of Charania v. Commissioner* [18]

In *Estate of Charania*, Mr. and Mrs. Charania were married in Uganda and did not enter into a pre-marital agreement. Mr. and Mrs. Charania were born in Uganda and were citizens of the United Kingdom. Mr. and Mrs. Charania were exiled from Uganda and moved to Belgium. Mr. Charania died domiciled in Belgium while owning shares in Citicorp stock. The estate argued that Mr. and Mrs. Charania were subject to Belgium's community property regime thereby only requiring 50% of the value of the Citicorp stock to be included in Mr. Charania's gross estate. The IRS contended that the shares were separate property, under English law, because the decedent and his wife did not select a community property regime after they moved to Belgium. [19]

The court began its analysis by looking to the marital domicile claimed by the estate at the time of death, i.e., Belgium.[20] According to the court, Belgian law determined whether or not the Citigroup shares were held as community property. Belgian law for this purpose included Belgian's conflict of laws principles, which provided that ownership of matrimonial property is governed by the law of the common nationality of the spouses. In this case, this meant the law of the United Kingdom, including English conflict of laws rules (i.e., *renvoi*[21]). According to English law, both the spouses were domiciled in the same country at the time of marriage, and English law would identify the matrimonial domicile of the couple as Uganda from the time of their marriage until they were exiled from Uganda.[22]

The next issue for the court was whether English law would recognize a change in matrimonial domicile to Belgium as effecting a change in the couple's property rights.[23] In particular, whether English law follows the doctrine of mutability or immutability. It was recognized by the court that English law is unsettled regarding this issue. After accepting expert testimony from both parties, the court was not convinced that the doctrine of mutability applied and was primarily left with the law applicable at the time

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[16] Fla. Stat. § 732.216 *et seq*.
[17] Fla. Stat. § 732.217.
[18] Estate of Charania v. Comm'r, 133 T.C. 122 (2009), affirmed in part and reversed in part by, 608 F.3d 67 (1st Cir. 2010).
[19] *Estate of Charania*, 133 T.C. at 72-73.
[20] *Id*. at 75.
[21] The "**renvoi** doctrine" provides that when the forum court's conflict of laws rules would apply the substantive law of a foreign jurisdiction to the case before the forum court, the forum court may apply the whole body of the foreign jurisdiction's substantive law including the foreign jurisdiction's conflict of laws rules. 16 Am. Jur. 2d Conflict of Laws § 6.
[22] *Estate of Charania*, 133 T.C. at 76.
[23] *Id*.

of marriage – i.e., English law. Thus, the court held that under English law, applied pursuant to Belgian conflict of laws principles, the full value of the Citigroup shares were included in Mr. Charania's gross estate as his separate property.[24]

5. Estate Planning Considerations

i. Ask where your client was married. Don't assume that the law of celebration of marriage is the applicable law governing marital property rights!

ii. Determine current and previous marital domiciles. Is there a chance the marital domicile will change again in the future? Ask about all current and previous nationalities. Remember the marital domicile in *Estate of Charania* came down to the common nationality of the spouses, which was not the current marital domicile claimed by the estate.

iii. Does the marital domicile have a form of community property regime? Does it provide a "vested interest"?

iv. Did the spouses elect-in or elect-out of a community property regime? Some jurisdictions require such document to be prepared by a local notary and filed with the local registry.

v. If they have changed marital domicile, will the current marital domicile look to the law of the previous marital domicile for determination of marital property rights under conflict of laws principles? Will the current marital domicile permit a "renvoi" back to the forum law or to a third country's internal laws?

vi. Does the applicable marital domicile apply a doctrine of mutability, immutability or combination of both?

vii. Is it possible to convert, or otherwise sever, community property under the marital domicile? Should you sever? Is it possible you may accidentally convert community property into separate property if property located in a jurisdiction that will not recognize?

viii. Should you consult foreign counsel?

[24] *Id.* at 77.

