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RE: Tax Basis of Hawaii Real Property Upon the Death of a Spouse in a Community Property State

Common Law Property vs. Community Property

Hawaii, like most other U.S. states, is a *common law* property jurisdiction. In common law states, property acquired during a marriage is not automatically considered to be owned by both spouses. Generally, the spouse who earns money and uses it to acquire property owns that property by themselves, unless they choose to share it with their spouse. However, common law states usually have rules to protect a surviving spouse from being disinherited. The theory underlying common law is that each spouse is a separate individual with separate legal and property rights. As a general rule, each individual spouse owns and is taxed upon the income that they earn in a common law jurisdiction.

Some other jurisdictions use the *community property* system. The theory underlying community property is analogous to that of a partnership. Each spouse contributes labor (and in some states, capital) for the benefit of the community, and shares equally in the profits and income earned. Thus, each spouse owns an automatic 50% interest in all community property, regardless of which spouse acquired the community property. Spouses may also hold separate property, which they solely own and control, but the law in community property states does not favor this. The community property system has been adopted by nine states: Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin. The U.S. Territories of Guam and Puerto Rico are also community property jurisdictions. Alaska has an optional community property system.

Application of the Law

In order to determine whether community property rules should apply, two preliminary determinations must be made: whether there was a legally valid marriage while domiciled in a community property jurisdiction; and whether property was acquired while spouses were subject to community property laws. Since a taxpayer's domicile may change over the period being examined, it may be necessary to allocate property and determine tax consequences under the laws of more than one state.

Determining Domicile

It is important to understand that "residence" and "domicile" are not the same thing. A person may have several residences, but can only ever have one domicile. Domicile is where the taxpayer has his or her true, fixed, permanent home and principal establishment and to which, whenever is absent, has the intention of returning.[1] In general, the taxpayer's residence may be treated as his or her domicile, unless the taxpayer asserts otherwise or is contrary to other facts in the case. Where a question regarding domicile arises, certain objective facts may indicate the taxpayer's intention to maintain a permanent home and principal establishment, including, but not limited to:

- Whether Taxpayer is on temporary work detail, attending school, or stationed in the military;
- Place of Taxpayer's employment;
- Location of Taxpayer's personal residence(s);
- Location of Taxpayer's family;
- Where Taxpayer's vehicles are registered;
- Where Taxpayer is registered to vote;
- Whether Taxpayer files a state tax return; and
- Other facts reflecting Taxpayer's involvement and ties to the community.

Once domicile is established, it is presumed to continue unless it is proven to have changed.[2] The domicile of a person does not change merely because of entry into the military and being stationed in another jurisdiction. Physical residence in a new state must accompany the present intention to make that state their new domicile. It is not enough to intend to establish domicile in that state at some future date. The same guidelines also apply to determining the domicile of students and prisoners.[3]

Moving Between Common Law and Community Property Jurisdictions

The specific tax consequences of moving from a common law property state to a community property state, or moving from a community property state to a common law property state, depends on the laws of the relevant states and/or jurisdictions. Hawaii and 15 other common law states have enacted the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA), which is found at Hawaii Revised Statutes (HRS) Chapter 510, sections 510-21, *et. seq*. The UDCPRDA generally preserves the community property nature of the previously-acquired property upon the death of one spouse, unless the couple has taken some action to sever the community property rights. The other states to have adopted the UDCPRDA are Alaska, Arkansas, Colorado, Connecticut, Florida, Kentucky, Michigan, Minnesota,

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1 *Smith v. Smith*, 206 Pa. Super. 310, 213 A.2d 94 (1965).

2 *Whitmore v. Commissioner*, 25 T.C. 293 (1955); *Myers v. Commissioner*, 11 T.C. 447 (1948).

3 *See* 24 AM. JUR. 2D DIVORCE AND SEPARATION § 215 (2008); 32A AM. JUR. 2D FEDERAL COURTS § 691 (2008); 28 C.J.S. DOMICILE § 33 (2008).

Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming.

With respect to real property located in Hawaii, the UDCPRDA applies to "[a]ll or the proportionate part of any real property situated in this State which was acquired with the rents, issues, or income of, the proceeds from, or in exchange for, property acquired as or which became, and remained, community property under the laws of another jurisdiction, or property traceable to that community property."[4] UDCPRDA also establishes a rebuttable presumption that such real property, and whose title to the real property in Hawaii is taken in a form which created rights of survivorship, is presumed not to be community property.[5] Because this presumption is rebuttable, it may be overcome by clear and convincing evidence that the married couple intended such property to be community property. For instance, the deed may say that title is held "jointly, with rights of survivorship, and intended to be community property." Other written documentation, contemporaneously executed at the time of the purchase of the real property, may also be acceptable.

Calculating the Basis of Hawaii Real Property that is Community Property at the Death of a Spouse

For income tax purposes, Hawaii conforms to the Internal Revenue Code (IRC) provisions on determining the basis of property, and looks to IRC section 1014 ("Basis of property acquired from a decedent"). If the rebuttable presumption discussed above can be overcome, and it can be shown with clear and convincing evidence that a married couple intended for property to be community property, then IRC section 1014(b)(6) may apply. This provision states that upon the death of a spouse, the surviving spouse is entitled to a full "step-up" in *basis* to the fair market of the real property at the date of death of the spouse (or, if applicable, the value of the property determined using the alternative valuation date). In other words, the value of the property may be readjusted for tax purposes to better reflect its most current value, rather than the value originally paid for it. This can have positive tax consequences by eliminating an inheritor's liability for capital gains taxes on any appreciation in the property's value during the decedent's lifetime.

IRC section 1014(b)(6) applies to the surviving spouse's one-half share of community property, as long as prior to death it was held by the survivor and the decedent as community property under any State, Territory, or foreign country's community property law and at least one-half of that entire community interest was included in the deceased spouse's gross estate. The following is a summary of all of the necessary steps, including the requirements of IRC section 1014(b)(6), to trigger a full step-up in the basis of Hawaii real estate that is community property at the death of a spouse:

- The married couple must reside in a community property state at the time the Hawaii real property was acquired, and documentation must evidence the desire to have the Hawaii

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4 HRS §510-21(2).
5 HRS §510-22(2).

real property considered to be community property; alternatively, if the property were acquired *prior* to becoming a resident of a community property state, the couple must take affirmative action to convert the property into community property;
- The Hawaii real property must be owned jointly with rights of survivorship;
- A Hawaii and federal estate tax return must have been filed for the decedent, unless it can be shown that such a return(s) was not required;
- The Hawaii real property must pass to the surviving spouse; and
- At least one-half of the value of the couple's whole interest in the community property was includible in the deceased spouse's estate.

If all of the foregoing requirements are not met, the HRS section 510-22 presumption applies, and the property will be deemed to *not* be held as community property. In that case, the basis for the Hawaii real property is one-half of the tax cost basis of the real property plus one-half of the fair market of the real property at the date of death (or, if applicable, one-half of the value of the property determined using an alternative valuation date). The following examples illustrate these principles:

Example 1. Married taxpayers purchase a residence while residing in Hawaii which is held in tenancy by the entirety. The taxpayers subsequently move to California, a community property state. After several years, Spouse dies unexpectedly, and Surviving Spouse decides to sell the Hawaii property. Surviving Spouse may not claim a full step-up in basis, since the property was not purchased during a period in which the community property laws of California applied.

Example 2. Same facts as Example 1, except that after moving to California, the taxpayers change the ownership of the Hawaii property to joint tenancy with rights of survivorship and intended the property to be community property. Provided that the other requirements are met, Surviving Spouse may claim a full step-up in basis.

Example 3. Same facts as Example 2, except that after moving to California and amending the ownership of the property to reflect their intent to hold it as community property, the taxpayers retire in Oregon, a non-community property state that has adopted the UDCPRDA. After Spouse's death, Surviving Spouse decides to sell the Hawaii property. Provided that the other requirements are met, Surviving Spouse may claim a full step-up in basis. UDCPRDA preserves the character as community property unless the couple took some action to defeat it.

Example 4. Married taxpayers reside in a community property state where the law provides that, unless shown to the contrary, any property acquired using community property funds is considered community property. The taxpayers sell a piece of community property real estate and use those funds to purchase a vacation home in Hawaii. After several years, Spouse dies unexpectedly, and the Surviving Spouse decides to sell the Hawaii vacation property. Unless evidence shows the contrary, the state of residence's presumption that it is held as community property applies. Provided that all of the other requirements are met, the Surviving Spouse is entitled to a full step-up in basis.

Example 5. Married taxpayers reside in a community property state and purchase real property in Hawaii, but demonstrate their intent to hold it as community property. Subsequently, the taxpayers retire to a common law jurisdiction, where the applicable laws convert community property into jointly held property. After several years, Spouse dies unexpectedly, and the Surviving Spouse decides to sell the Hawaii real property. Because the community property status was severed, the Surviving Spouse is not entitled to a full step-up in basis.

For more information, please contact the Rules Office at (808) 587-1530 or by email at tax.rules.office@hawaii.gov.

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