THE SAVINGS POTENTIAL OF TENNESSEE COMMUNITY PROPERTY TRUSTS

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Since 2010, a tax avoidance technique has existed in Tennessee that is becoming more and more popular among the estate and financial planning communities. This technique, known as the Community Property Trust, allows a married couple to transfer property into a joint revocable trust to minimize capital gain taxes when the property is later sold. While this technique has long been available in the nine community property states, only three non-community property states have enacted legislation to allow for it – Alaska, South Dakota and Tennessee.

Under the Tennessee Community Property Trust Act (T.C.A. Sections 35-17-101 et seq.), a married couple can create a Community Property Trust through a properly drafted trust document meeting the following requirements: (1) it expressly states that it is a Tennessee Community Property Trust; (2) a "qualified trustee" is appointed; (3) it is signed by both spouses; and, (4) it contains a notice of the consequences of establishing the trust.

Property that is owned by one (or both) spouse(s) can be transferred into the trust, to be held by both spouses as community property. With the proper wording, the trust can later be amended or revoked. If the couple divorces, the trust terminates and the property will be divided equally between the spouses, unless they agree otherwise.

As mentioned above, the biggest advantage of a Community Property Trust is that, under federal tax law, the property receives a full step-up in basis at the death of the first spouse. The benefit of this is that the surviving spouse can then sell the property without (or with reduced) capital gains taxes (assuming the property has increased in value since acquisition).

As an example, assume a husband owns rural farmland that he inherited from his parents. The farmland was worth $500,000 when the husband took ownership, but is currently worth around $2,000,000. If the husband sold the property now, he would pay federal capital gains taxes on the $1,500,000 gain. The husband, however, doesn't need the cash now. He intends for the property to be sold when the first spouse passes away, so the proceeds can provide care and support for the surviving spouse. By transferring his farmland into a Community Property Trust now, the husband ensures that it is jointly owned by both spouses and receives a full step up in basis at the first death, so that it can then be sold with no or minimal capital gains taxes.

The Tennessee Community Property Trust is not restricted to Tennessee residents, although the location of tangible property or real estate may be a factor in determining whether to utilize this type of trust. As indicated above, however, a key requirement is to appoint a "qualified trustee," which must be either a Tennessee resident, or a bank or trust company authorized to act as a fiduciary in Tennessee. While the spouses establishing the trust may serve as trustees (if they are Tennessee residents), it is often recommended to name a corporate fiduciary as successor trustee, in the event one or both spouses can no longer serve. Pendleton Square Trust Company is authorized to act as a "qualified trustee," either as current trustee, or to serve only after an individual trustee becomes disabled or passes away.

A Community Property Trust is not appropriate for every situation and could, in fact, have disadvantages, depending on your goals, property involved and other factors. Or, a different type of trust, such as one that provides creditor protection, may be more applicable to your situation. This article should not be construed as tax or legal advice, and we recommend speaking with a Tennessee licensed attorney if you think a Community Property Trust or other type of trust may be right for you.

About the author: Derek Church is president and chief operating officer of Pendleton Square Trust Company, a provider of trust advisor services in Nashville, TN. Nothing in this article should be construed as providing legal or tax advice regarding your specific situation.