# Florida May Sweeten the Pot for Michigan Snowbirds

By Nicholas Reister, George Gregory, and Neal Nusholtz

## Community Property Basis Step Up

On August 22, 2020, the Real Property, Probate and Trust Law Section of the Florida Bar voted to send a proposed bill to the Florida legislature entitled "the Florida Community Property Trust Act of 2021." The Act was passed by the Florida Senate on April 21, 2021, and, at this writing, is pending in the Florida House. It has an effective date of July 1, 2021. It would permit married couples to create community property in Florida by transferring assets to a Florida community property trust. The purpose of the bill is to allow residents "to take advantage of significant income tax benefits."[1] The referenced significant tax benefits accrue under Internal Revenue Code ("IRC") 1014 (b)(6). That code section gives special treatment to a surviving spouse who has a one-half interest in community property held "under the community property laws of any State or possession of the United States or any foreign country." IRC 1014(b)(6) treats the surviving spouse's share of community property, the one that he or she *already* own, as if it had been inherited from their deceased spouse for purposes of basis step-up on death.

A surviving spouse's basis in entireties property is smaller than if the same property is held as community property. Suppose a stock portfolio held as entireties property had been bought for $500,000 and is worth $1 million on the death of the first spouse. The basis for that surviving spouse will be $750,000 (one-half the original cost plus one-half the fair market value on the date of death).[2] If the stock portfolio were held in a Florida community property trust, the survivor's basis will be the full step up of $1 million.

A larger basis on the first death can save income taxes for a widow or widower in three ways: (1) lower capital gains on sale; (2) increased depreciation on depreciable property; and (3) an increase in the 20 percent qualified business income deduction under IRC 199A(b)(2). Because of income tax benefits of community property, common law states such as Alaska, Tennessee, South Dakota, and Kentucky have enacted optional community property statutes like the one proposed by the probate section in Florida.[3]

## Tax Cases and Rulings in Regard to Community Property

Community property can have an elective income splitting attribute. When each spouse has a vested interest in the community income, each spouse may report one-half of earned income on separate income tax returns. *Poe v Seaborne,* 282 US 101 (1930). *See also Angerhofer v Commissioner*, 87 TC 814 (1986). Income splitting is not a major factor to be considered in an optional community property law because, today, most married couples file joint income tax returns. Also, the U.S. Supreme Court has ruled that an optional community property statute will not allow spouses to split income on future wages because electing community property treatment is an impermissible assignment of income that should be taxable to the assignor. (*See Harmon,* at endnote 3). No cases or rulings have addressed the issue of basis step-up after the death of a spouse when that basis step-up has been derived from the use of an optional community property law. Cases and rulings that have addressed community property have arisen mostly in regard to the income tax splitting aspect of community property. This is understandable. Basis step-up happens once during the lifetimes of a married couple while a desire to split income and report that income on two separate tax returns can happen annually.

Optional community property arrangements are permitted under a general rule that spouses can enter into agreements as to how they want property held as long as such tenancies are

permitted by local law.[4] Based on Washington courts' enforcing its optional community property law in non-tax context, the IRS reversed a long-held position of not recognizing Washington's optional community property law for Washington residents in Rev. Rul. 77-359. It stuck by its litigation victory involving income splitting in *Poe v Seaborne,* 282 US 101 (1930) and generally required that such agreements be in writing. Based on that Revenue Ruling, if there is a transfer of property, such as in the case of a transfer to an optional community property trust, then future income from that property will be split between the spousal beneficiaries of the trust.

### The Calculation for Choosing Florida Domicile to Save on Taxes Has Changed

Prior to the new Florida statute, Michigan citizens who wintered in Florida might have chosen to switch their domicile to Florida because Florida does not have a state income tax. Florida is the number one state for receiving people who have moved from other states.[5] The current financial calculation made by Michigan snowbirds for deciding whether to claim Florida as their domicile will change after the Florida community property statute is enacted because the amount of tax savings from changing domicile to Florida will have increased—a domicile change after the new Florida statute could include a savings in both state *and* federal income taxes.

### Domicile and Choice of Law

The particular details of the Florida statute are unimportant to Michigan attorneys inasmuch as the pertinent documents will be drafted by attorneys licensed in Florida and by Florida trust companies. What will be important to Michigan attorneys is being able to advise their Michigan clients with Florida residences whether they should choose Florida as their domicile, so they can take advantage of a full step-up in basis for marital property that should occur under the new Florida statute.

In general, "the domicile of an individual is his true, fixed and permanent home and place of habitation. It is the place to which, whenever he is absent, he has the intention of returning." *Martinez v Bynum*, 461 US 321, 331, (1983). Domicile means "physical presence in a place in connection with a certain state of mind concerning one's intent to remain there." *Holder v Martinez Gutierrez*, 566 US 583, 592 (2012). Domicile does not control whether a state may tax a particular individual. If domicile was the predicate for state income taxes, then itinerant taxpayers could mount a successful defense to the payment of state taxes by proving that their residency was temporary and that they intended to move to a location in another state at some point in the future. "Enjoyment of the privileges of residence within the state, and the attendant right to invoke the protection of its laws, are inseparable from the responsibility for sharing the costs of government." *Lawrence v State Tax Comm'n of Mississippi*, 286 US 276, 279 (1932).[6]

Domicile generally controls community property treatment because domicile is one of the seven connecting factors the U.S. Supreme Court has identified as part of its analysis when determining which laws of which jurisdiction shall govern a particular legal action. *Lauritzen v Larsen*, 345 US 571, 586 (1953). Domicile is a connecting factor that links a person with a particular legal system.[7] "[T]he law of an individual's domicile generally governs such matters as the distribution of his property after death, the probate of a will and the appointment of an administrator [which] generally occur in the domicile of the deceased." *Martinez v Bynum*, *supra* at 340.

Like many choice of law issues, public policy of the various states can come into play. For example, the location of real estate often governs which law applies to the real estate for many purposes. However, our focus is on federal tax treatment, which is dealt with in the next section.

## Community Property and Choice of Law Cases and Rulings for Federal Tax Purposes

Income splitting community property cases have addressed the relationship between domicile and community property treatment because to achieve income splitting under a community property regime, a taxpayer must establish domicile in a community property state. *Gates v Commissioner*, 10 TCM 1002 (1951), aff'd 199 F2d 291 (1952).

Community property income splitting is particularly attractive to married couples when one of the spouses is a nonresident alien. For instance, a U.S. citizen married to a Spanish citizen living with his or her spouse in a community property state (Spain) will only pay U.S. taxes on one-half of the U.S. citizen spouse's income. *See West v United States*, 44 AFTR2d 79-5094, 79-2 USTC P 9413 (US Ct of Claims June 1, 1979). *See also Cavanaugh v Commissioner*, 42 BTA 1037 (1940), aff'd 125 F2d 366 (9th Cir 1942) (citizen husband domiciled in California while non-citizen wife resided in England). The tax savings from a marriage to a non-resident alien spouse has driven much of the litigation involving domicile and community property.

Efforts to report half of a citizen's income have failed when domicile in a community property regime was not established. *See Taira v Commissioner*, 51 TC 65 (1969), *Niki v United States*, 484 F2d 95 (9th Cir 1973); and *Blumenthal v Commissioner*, 60 F2d 715 (2nd Cir 1932). Also, as indicated above, income will not be split if the particular community property law did not allow for the income to be split. *See Lane-Burslem v Commissioner*, 659 F2d 209, 214–15 (DC Cir 1981) and *Santiago v Commissioner*, 61 TC 53 (1973), aff'd 510 F2d 223 (DC Cir 1975).

## Practical Advice

Domicile can change. As the Tax Court has explained, "The domicile which a person once has, whether given by law, or acquired through the exercise of choice, continues until another one is gained." *Desmare v United States*, 93 US 605 (1876). *Gates v Commissioner* 10 TCM 1002 (1951).

The *Gates* case addresses a situation where a taxpayer living in a common law state (Colorado) claimed his domicile was in a community property state (Louisiana). In the *Gates* case, the taxpayer's family owned a rubber company in Denver, Colorado. Before entering college, the taxpayer's home was in Denver. In 1942, after obtaining his college degree in engineering, Mr. Gates went to work for the Firestone Rubber Company in Baton Rouge, Louisiana. The taxpayer resided in Louisiana and filed tax returns there for 1942-1945. He got married in 1943. In 1946, the taxpayer's father sent him a letter asking him to join the family business in Denver. The taxpayer subsequently moved back to Denver. Thereafter, Mr. Gates discovered the benefits of community property income splitting and amended his 1944 tax return to treat his income as community property so his wife would report one-half of his income on her separate return (this was before lower joint rates would save taxes for married couples in 1955). Mr. Gates claimed that Louisiana was his domicile and that he intended to return there from Denver. The Tax Court disagreed: "Petitioner went to Baton Rouge, Louisiana, to gain experience in the synthetic rubber industry and always had a fixed intention of returning to Colorado, to become associated with The Gates Rubber Company." The *Gates* court explained:

> It is our conclusion from all the evidence that while the petitioner intended to reside in Baton Rouge until he had gained experience in the synthetic rubber industry, even though this might be for an indefinite period of time as such, he always had a fixed and definite intention to return to Colorado and become associated with the family corporation. "A change of abode with present intent to return to the former abode upon the contemplated happening of an event in the indefinite future, as business dispatched, health recovered, employment ended, employer's re-

> call, is not a change of residence or domicile". *United States v. Knight*, 291 Fed. 129; *affd.*, 299 Fed. 571; *Pietro Crespi*, 44 B. T. A. 670, 676 [ Dec. 11,845]. It follows that petitioner did not abandon his Colorado domicile, nor did he establish a domicile in Louisiana.

Changing domicile can be evidenced on paper. Both Michigan (Form 3799–Statement to Determine State of Domicile[8]) and Florida (Declaration of Domicile[9]) have forms that can be filed to declare domicile ahead of any dispute over domicile to help establish a bona fide intent to treat Florida as a domicile.[10] The Michigan form includes a list of questions that can be used to judge whether the following criteria are met:

1. You have a specific intent to abandon your domicile;
2. You have a specific intent to acquire a new domicile; and
3. You are physically living in your new domicile.

The Michigan form is in the nature of an application filed with the State of Michigan Department of Treasury to overcome the presumption of residency (Mich. Admin. Code R. 206.5) and is signed under penalties of perjury. The Florida form is in the nature of a declaration filed in the county of residence and only requires that the identity of the signor be verified by a notary.

At the time this article was written, there was uncertainty about the future of the basis step-up law. During the 2020 presidential campaign, candidate Joe Biden had included in his tax plan replacing the basis step-up rule with a carryover basis rule. A carryover basis rule might not be passed because it is associated with the unpopular problem of establishing a decedent's basis in assets acquired years earlier. Biden's proposal would be the third time in history that a repeal of the basis step-up rule had been proposed. The first two times the proposals were subsequently abandoned.

A carryover basis rule was included in the Tax Reform Act of 1976. That change was suspended in the Revenue Act of 1978. The basis step-up rule was re-established in the Crude Oil Windfall Profits Tax Act of 1980. The carryover basis rule happened again for one year under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, where there was an optional carryover basis when the estate tax was not in effect. Basis step-up on inherited property was reestablished in the American Taxpayer Relief Act of 2012.

### Why the Florida Statute Would Be Special for Michigan Snowbirds

Unlike the optional community property statutes in other states, the proposed Florida statute has a unique benefit for Michigan snowbirds who have homes in Florida. The optional community trust statutes in Florida, Alaska, Tennessee, South Dakota, and Kentucky require only that the trustees of optional community property trusts be residents in those states. This appears to have been done to attract trust business from residents of common law states. But, as indicated by the authorities cited above, if a spouse is not domiciled in the jurisdiction of a state that has community property, that can jeopardize community property status. The Florida statute may offer an opportunity to remedy that situation by Michigan residents willing to take the necessary steps to claim Florida as their domicile.

Demonstrable evidence may help establish domicile. In a Minnesota case, a husband moved to Florida to retire and take up competitive trapshooting at the Silver Dollar Trap Club, which was one of the largest shooting clubs in the United States and offered daily competitive shooting events. His wife stayed behind in Minnesota to take care of their disabled daughter.[11] Minnesota has a 26-factor test.[12] The Minnesota Tax Court determined that the husband had "an actual and honest subjective intent to make his Odessa, Florida residence his home on a permanent basis."[13] The taxpayer demonstrated an intent to change residence beyond keeping warm for a few months a year. As evidence, trap shooting in Florida is a physically ob-

servable event. Moving to Florida to save federal and state income taxes and setting up an optional community property trust could have some evidentiary effect. Should Florida domiciliary be disputed, bona fide intent will need to be proven with something other than the self-serving words from the taxpayer's mouth.

### Notes

1. https://www.rpptl.org/uploads/RPPTL%20EC%20Zoom%20Meeting%20Agenda%20082220-updated%20.pdf.
2. *See* IRC 2040(b).
3. The U.S. Supreme Court has labeled such statutes as "optional community property laws." *Commissioner of Internal Revenue v Harmon*, 323 US 44, 44 (1944).
4. Rev. Rul. 97-98. *See also Murphy v Commissioner*, 342 F2d 356 (9th Cir 1965) and LTR 202006002 (where spouses agreed that property in trust in a community property state would be community property).
5. https://www.census.gov/library/stories/2019/04/moves-from-south-west-dominate-recent-migration-flows.html.
6. Michigan defines a resident under MCL 206.18 as "an individual lives in this state at least 183 days during the tax year or more than 1/2 the days during a taxable year of less than 12 months."
7. Collier, J. (2001). Domicile and residence. *In Conflict of Laws* (pp. 37-59). Cambridge: Cambridge University Press.
8. https://www.michigan.gov/documents/taxes/3799_373276_7.pdf.
9. https://www.mypalmbeachclerk.com/records/recording/declaration-of-domicile.
10. "[B]ona fide domicile in a state is 'essential to give jurisdiction to the courts of such state.'" *Williams v State of North Carolina,* 325 US 226, 240 (1945).
11. *Zauhar v Commissioner*, No 9139-R, 2020 WL 4912971 (Minn Tax Ct Aug 19, 2020).
12. Minn. R. 8001.0300 RESIDENT AND DOMICILE DEFINED; CONSIDERATIONS.
13. *Id.* at *1.

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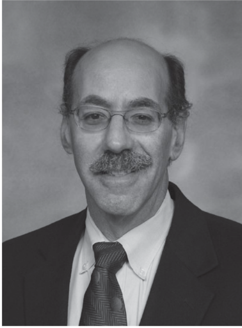

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