

Article for RNB: June 2007

Topic: Property Management and Holding Title to Rental Property

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1. Introduction

Ownership of real property can take a great number of forms. The difficulty is often in deciding which form of title is right for you, your family, and your business. The facts of your situation will determine how title to property should be held, and properly selecting title form may involve transferring or re-titling property you already own. This article will provide an overview of a relatively new form of title: community property with right of survivorship [“CPWROS”].

2. Community Property With Right of Survivorship

a. Pre-CPWROS Planning

In acquiring real property before 2001, married couples in California often had to perform a bit of strategic planning when taking title to property. To take maximum advantage of federal taxation laws, married couples would take title to property as joint tenants with right of survivorship and then use a marital transmutation agreement to change the joint tenancy property into community property. As joint tenants, each spouse would have an undivided one-half ownership interest in the property. The right of survivorship feature allows the deceased tenant’s property ownership to immediately pass to the surviving tenant upon the first tenant’s death. Generally, no court administration is needed. The transmutation agreement would then convert property to community property.

Community property is generally any property acquired during marriage that is not separate property of either spouse. Under the federal taxation system, community property receives a full step-up in basis upon the death of either spouse.

b. Stepped-Up Basis

At this point, a simple explanation of basis step-ups may be useful. A step-up in the basis of property is fairly simple to understand, and a step-up provides an excellent tax benefit. When you acquire and maintain real property, you invest a certain amount of money in it, whether this money represents the purchase price or improvements you make to the property. This investment becomes your basis in the property. When you sell or dispose of the property, you will recognize a capital gain. This gain is equal to the current fair market value of the property (i.e., the amount you received in exchange for the property) minus your basis. So if the property has appreciated in value over time, you would want basis to be as close as possible to the fair market value so that you could reduce the amount of your gain. Reducing gain reduces the taxes that must be paid. A step-up in basis allows you to increase your basis in the property without recognizing any gains, which is a good thing. In a way, stepped-up basis is like a free investment made by the government on your behalf.

In a joint tenancy with right of survivorship, the federal taxation system only allows a step-up in basis for the deceased spouse's joint tenancy interest. Thus, the surviving spouse receives a stepped-up basis in the property equal to the fair market value of the deceased spouse's joint tenancy interest. Fair market value is determined at the time of the deceased spouse's death.

c. CPWROS

But the California legislature wanted to make it easier for California married couples to take advantage of the federal tax benefits. On July 1, 2001, a new form of title became available to Californians: community property with right of survivorship. This form of title utilizes the joint interest and right of survivorship features while allowing the tax benefit of stepped-up basis for community property.

The biggest advantage of CPWROS is that it provides a step-up in basis for real property owned by a married couple in California. When the first spouse dies and leaves the property to the surviving spouse, the surviving spouse receives a step-up in basis for the deceased spouse's one-half interest in the community

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property. The tax code also provides that the surviving spouse's interest in community property is treated as having been acquired from a decedent, so it also receives a step-up in basis. In effect, the surviving spouse has acquired a stepped-up basis in all community property of the marriage by using CPWROS.

The other important advantage of CPWROS is the right of survivorship feature. As stated above, the right of survivorship allows property to pass immediately between joint tenants upon the death of one of them. Probate is not required for this property to vest in the surviving joint tenants, thus avoiding the time and expense of a lengthy court administration.

However, using CPWROS may produce undesirable results in certain situations. For instance, creditors can seek payment from the community property of a debtor spouse. By putting property in CPWROS, the non-debtor spouse may subject a particular item of community property to attachment by a creditor. Property that passes between spouses under joint tenancy with right of survivorship avoids creditor claims against the debtor spouse's interest. Another example arises in bankruptcy. During bankruptcy, control of the community property of the debtor-spouse passes to the bankruptcy trustee or debtor in possession. This means that the non-debtor spouse loses control of that item of community property until the bankruptcy proceedings have ended. However, if property is held in joint tenancy form, only the debtor spouse's one-half interest is subject to the bankruptcy trustee's control. This demonstrates that careful planning is required when using CPWROS to hold property.

3. Trusts

It is important to note that a properly drafted revocable living trust provides many of tax advantages and other benefits as well. As part of an estate plan, many people transfer their property to a revocable living trust. For a married couple with a well-drafted estate plan, transferring real property to a trust is often the best solution. A trust is a legal entity separate from the natural persons who create it. Trusts can remove real property from the estate of the deceased spouse and allow it to pass free of probate. Furthermore, unlike CPWROS, a trust allows the couple to plan far into the future and they can outline the disposition of many different properties, rather than a single piece of real property. The use of a trust is not a panacea, but it often proves to be a very valuable tool for married couples.

4. Conclusion

The goals, finances, and assets of your marriage and your business will all play a role in determining how you should hold title to real property. For some married couples, the CPWROS provides a useful tool for estate and tax planning due to the increased step-up in basis and its avoidance of probate. However, the CPWROS may not be the best option for your circumstances, as other planning methods, especially the revocable living trust, may prove more beneficial. You should consult with an attorney to help determine whether the CPWROS is right for your situation.

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