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Articles

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ARTICLES

Current financial transaction and stock transfer taxes are ineffective and administratively complex. Developments in technology leading to high-frequency trading, increased speculation, and retail investor mobilization via digital trading platform are all concerns that are not accounted for through current statutory language. In response to these concerns, the United States government and legislature of New York propose legislation to re-enact or renew existing stock transfer taxes.

This Article first examines the history of financial transaction taxes both at the state and federal levels. Imprecise language, ineffective administration, and constitutional violations were the Achilles-heel of stock transfer taxes of the past. Clear guidance from the United States Supreme Court and insights gained over the past forty years will allow for a more effective approach.

Next, this Article examines the approach to financial transactions taxes in Europe, where implementation issues led to long-term successes or short-term failure. Taking lessons from three nations, The United Kingdom, France, and Sweden, will prove helpful in deciding the best approach and design for U.S. financial transaction and stock transfer taxes.

Third, this Article addresses high-frequency trading, a new phenomenon in the financial world which utilizes computer software and theoretical mathematics to execute trades in a matter of seconds. This technology was not a consideration when financial transaction taxes were first implemented and will be a key piece in effective legislative drafting. Effective legislation should minimize risks associated with high-speed, speculative trading and support traditional market functions.

This Article concludes by critically analyzing existing statutes and proposed legislation at both the federal and state level and proposes a course of action for New York given the recent developments in trading technology, society, and multijurisdictional taxation.

This article examines how opposing attorneys found common ground to allow them to operate with civility and professionalism while representing adversarial parties over a course of years. The concept of "sportsmanship" has historically been rooted in competitive sport, particularly organized sports. In contrast, many attorneys are required to act within the rules and guidelines of ethics and professional responsibility to conduct their legal practice, but are rarely given concrete examples of how to act in accordance with these rules, resulting in attorneys often only giving a nod to these rules and the spirit of civility embodied within them. This Article explores how two opposing attorneys used commonalities based on their mutual interest in the sport of cricket to demonstrate the importance of how they found the "Middle Ground" between them as opposing counsel over a period of years. They investigate how to maintain civility dealing with potential challenges as opposing attorneys via explorations and evaluations of their own unique personal and historical backgrounds and ideologies. The Article helps describe the basis for and examples of their best practices to maintain civility in the courts, with their clients, with expert witnesses, and most importantly with opposing attorneys.

Despite the "currency" name, in the United States Treasury treats cryptocurrency as property for tax purposes. In fact, the United Sates federal government has passed no formal laws that seek to manage the use, trade, purchase, sales, or exchanges of cryptocurrency for tax purposes. Instead, the IRS established a tax policy by publishing Notice 2014-21, which requires cryptocurrencies receive tax treatment as property, and as such, those tax principals related to property transactions have become the rules applied to cryptocurrency transactions. IRS Notice 2014-21, and its accompanying Frequently Asked Questions web page, are the cornerstone and the only form of guidance for US taxpayers when reporting the tax consequences of these transactions.

The mechanics of taxable property transactions highlights the inefficiency of the IRS policy when analyzed against proof of stake blockchain due to the frequency that a taxpayer receives those proof of stake rewards, coupled with normal market conditions that create a fluctuating fair market value for the property over time. The nature and frequency at taxpayer may receive these "rewards", coupled with the general practice of holding any crypto-property as an aggregate lump sum, creates a situation in which the taxpayer may have several dozen tax bases for what they consider to be one unit of property, and thus a challenging accounting trap for even the most seasoned tax professional.

The purpose of this paper is to show, that while the policies in Notice 2014-21 are reasonable, that reasonableness can no longer hold true due to taxpayer expectations and ever-changing landscape of in the cryptocurrency and blockchain space. As a regulatory agency, it is outside of the delegated authority for the IRS to create a complex taxing regime on its own, and therefore Congress must act.

Limited liability is the touchstone of the corporate form and aims to protect individual and corporate investors in the name of societal growth and economic prosperity. However, corporate actors sometimes stretch limited liability beyond its intended form and exploit their limited liability status to conduct shady or illegitimate business practices in an effort to make a quick buck or avoid repaying corporate debts. In such instances, courts may invoke the doctrine of piercing the corporate veil to hold corporate actors liable for the debts of the enterprise. Unfortunately, the piercing doctrine is one of the most muddled and incalculable doctrines in corporate law and remains a topic of great unrest in legal scholarship.

Property taxes are currently the dominant form of local government taxation in the United States, and have been for some time. While property taxes are the norm and there are reasons why it is a favored form of taxation, there are also reasons why property taxes are a form of regressive taxation. Ultimately, if local governments are to replace property taxes with less regressive forms of taxation, they will need to innovate and change the structure of local taxation.

The unique tax structure of the S corporation, which corresponds with its high popularity as an entity choice, makes the S corporation a likely and worthy target in either an asset acquisition or a stock acquisition. The elections under Section 338(h)(10) and Section 366(e) of the U.S. tax code, which serve to treat a stock sale as a deemed asset sale for tax purposes, make the stock acquisition of an S corporation even more worthwhile for all parties involved. These elections allow the parties to proceed with the ease of transferability of a stock sale, while benefiting from the favorable tax consequences of an asset sale. This Article explores the interaction of these two sections of the U.S tax code, Section 338(h)(10) and Section 336(e), with S corporation targets in the context of asset and stock sales. Part I of this Article outlines the qualifications, limitations, and taxation of S corporations. Part II explores various considerations of the parties involved in a transaction when determining acquisition structure. Part III details the requirements for making an election under Section 338(h)(10) and Section 336(e). Part IV of this Article identifies various considerations involved in deciding whether to structure a transaction as an asset or stock acquisition. Part V discusses the tax treatment and consequences of Section 338(h)(10) and Section 336(e) elections. Part VI highlights some of the proposed changes to the U.S tax code and the resulting effects on the popularity of the S corporation target in future business acquisition transactions.

Community property law is often misunderstood by common law practitioners. In this critical analysis, Alan Gassman and Brock Exline provide insight to guide common law practitioners through the intricacies of this complex legal landscape. The quagmire of case law presents numerous traps for the unwary, particularly when couples transition from community property states to common law states, or vice-versa. The authors emphasize the essential concepts and planning strategies such as community property trusts, transmutation, commingling, and the critical, but often overlooked, double step-up in basis under Internal Revenue Code §1014(b)(6).

Cautionary advice is given regarding the potential loss of community property assets to creditors, a concern that may surpass the advantages of a double step-up in basis for income tax purposes. The article explores the complexities arising when couples transition from community property to non-community property states, weighing the decision to transmute assets, and addressing income tax basis planning challenges. The article underscores the importance of consulting with experts familiar with both community and non-community property state laws when dealing with such transitions.

Potential pitfalls for the unwary are discussed, including unintended taxable gifts, the intricacies of joint revocable trusts, the necessity of spousal consent on transfers of community property, and more. A historical perspective outlines the evolution of community property laws in the U.S., emphasizing variations among the traditional community property states. Key considerations, including creditor laws and property characterization differences highlight the importance of state-specific expertise. The advent of "opt-in" community property trust legislation in Alaska, Tennessee, South Dakota, Kentucky, and Florida's recent enactment prompts critical examination. While offering potential income tax benefits, concerns are raised about forfeiting creditor protection. Additionally, the authors explain the uncertainties associated with the double step-up in basis for assets held in elective community property trust systems.

Case law is explained to illustrate the preservation of community and separate property assets and the intricacies surrounding their treatment. Specifically, the authors provide a critical analysis of choice of law principles through the examination of relevant case law and present a comprehensive view of how these principles influence, often inconsistently, the disposition of movable and immovable assets in community property scenarios.

The authors delve into trust planning constraints and propose alternative strategies, including the use of Joint Exempt Step-Up Trusts (JEST Trusts).

In essence, this paper serves as a comprehensive guide, offering practitioners a thorough understanding of the estate planning challenges and intricacies that will undoubtedly arise when dealing with migratory couples, with practical insights and strategic recommendations for navigating the complexities.

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STOCK TRANSFER TAXES IN THE MODERN AGE

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INTRODUCTION

Existing stock transfer taxes ("STT") are ineffective. In today's digital age, barriers to reduce taxpayer migration, i.e., movement to lower-taxed jurisdictions, are significantly lower than when financial taxes were conceived.[1] In the United States, STT take the form of a diminutive federal tax intended to fund the Securities and Exchange Commission.[2] Currently, New York is the only state that has this tax on the books, but as of 1981, provides a one-hundred percent elective rebate.[3] In Europe, several countries attempted to impose STT, notably, France, the United Kingdom, and Sweden, all to varied levels of success.[4] Typically, these taxes result in migration from the jurisdiction imposing these taxes to those that do not impose such a tax.

Often, drafters of financial transaction taxes ("FTT") intend to curb investment speculation by creating barriers to entry into the investment world.[5] However, these tax barriers often prove to be too low, failing to prevent numerous financial crises that dramatically shifted the economic landscape over the last century. The advent of mass digital retail investment and the onset of institutional algorithmic trading serves to further reduce the barriers to entry to the investment world and were not considerations when these taxes were implemented in the United States.[6] In light of these new developments, a review of existing and proposed legislation is required to determine the best approach to imposing STT.

Proposals at federal and state levels intend to levy a tax on all sales of securities or security agreements—essentially a sales tax

1. *See* Chris Edwards, *Tax Reform and Interstate Migration*, CATO INST. (Sept. 6, 2018), https://www.cato.org/tax-budget-bulletin/tax-reform-interstate-migration (discussing the impact of the Tax Cuts and Jobs Act on taxpayer migration). For specific data regarding taxpayer migration, see Internal Revenue Service Tax Statistics, *SOI Stats - Migration Data*, IRS, https://www.irs.gov/statistics/soi-tax-stats-migration-data (last visited June 5, 2023).

2. *See generally* 15 USC § 78a et seq. (1934).

3. *See* N.Y. TAX L. § 280-A (2012).

4. *See infra* Section I(B).

5. *See* Colin Miller & Anna Tyger, *The Impact of a Financial Transactions Tax*, TAX FOUND. (Jan. 23, 2020), https://taxfoundation.org/financial-transaction-tax/#History (discussing the history and past implementation of financial transactions taxes).

6. *See* Concept Release on Equity Market Structure, Exchange Act Release No. 34-61358, 75 Fed. Reg. 3594, 3606 (Jan. 21, 2010).

on trading.[7] While this approach may raise a significant amount of tax revenue for the taxing jurisdiction, a broad-brushed approach will likely lead to both administrative concerns and a potential for taxpayer migration. The ability for investors to move and invest freely will inhibit a taxing authority's ability to collect on this tax and other beneficial taxes like corporate income, property, and personal income taxes. As evidenced by the Swedish approach, a federal-level FTT,[8] this type of tax will lead to mass migration to a low-to-no tax rate jurisdiction.[9]

A modern development in the financial world is high-frequency, algorithmic trading, where physicists, mathematicians, and statisticians craft computer algorithms that execute millions of trades per second, drastically affecting market trends and volume.[10] This activity is known as high-frequency trading ("HFT"), where traders attempt to maximize profit potential by locating their trading systems as close to the exchange as possible to minimize latency, the delay between sending and receiving data, possible.[11] This phenomenon is relatively new, as prior to the Great Recession in 2008, HFT constituted a small percentage of all trading volume; however, beginning in the late 2010s into today, HFT firms constitute a vast majority of market activity.[12] The danger of this practice is highlighted in the Flash-Crash of 2010, where an algorithm set off a security selling frenzy, where the Dow Jones lost approximately nine percent of value in just ten minutes, ultimately costing the market one trillion dollars.[13] Empirical data

7. *See* Assemb. B. A7791B (N.Y. 2021); *see also* Wall Street Tax Act of 2021, H.R. 328, 117th Cong. (Jan. 15, 2021).

8. For more information regarding the Swedish approach to FTT, see *infra* Section I(B)(3).

9. *See* John Y. Campbell & Kenneth A. Froot, *International Experiences with Securities Transaction Taxes* 6–7 (Nat'l Bureau of Econ., Rsch. Working Paper No. 4587, 1993), https://www.nber.org/papers/w4587#:~:text=STTs%20give%20investors%20incentives%20 to,reducing%20the%20volume%20of%20trade (discussing the efficacy of various approaches to financial transactions taxes globally).

10. *See* Alice Laplante, *Trading at the Speed of Light*, STAN. L. SCH.: STAN. LAW. (Nov. 13, 2014), https://law.stanford.edu/stanford-lawyer/articles/trading-at-the-speed-of-light/ (discussing the scientific nature and theories behind high-frequency trading).

11. See *infra* Section II(B) for a discussion regarding latency and technological advancements in High-Frequency Trading.

12. *See* Chris Gaetano, *Study: High Frequency Trading Imposes $5 Billion 'Tax' on Investors*, THE TRUSTED PRO., THE NEWSPAPER OF THE NY STATE SOC'Y OF CERTIFIED PUB. ACCTS. (Jan. 28, 2020) (indicating that seventy-five percent of all market value is based in high-frequency trading).

13. *See* Ian Poirier, *High-Frequency Trading and the Flash Crash: Structural Weaknesses in the Securities Markets and Proposed Regulatory Responses*, 8 HASTINGS BUS.

indicates that although HFTs were not the impetus for the crash, their very nature accelerated and amplified the underlying speculation and damage.[14]

While many of these "flash crashes" occur at a rate much faster than what a retail or semi-sophisticated investor may notice, HFTs are overwhelming investors' abilities to make calculated, profitable decisions. The traditional functions of the stock market—the ability for investors to access and invest in corporations, and for corporations to raise capital—are hindered by computers and mathematicians attempting to arbitrage out the likes of new investors, main street investors, pension funds, and even established investing institutions.

In response to the Great Recession, flash-crashes, the Occupy Wall Street movement, and other political factors, calls to implement FTT are on the rise globally and in the United States.[15] To curb an inevitable financial crisis led by out-of-control high-speed HFT algorithms, New York is in a unique position to both generate tax revenue and protect the sanctity of the global financial market through revised legislation. This legislation should include clear language, in light of the recent *Wayfair* decision, to ensure that the STT is considered a sales tax, and will have the secondary effect in mitigating HFT by imposing a tax rooted in trading volume.

To that end, this Article focuses on the STT currently in place in New York, and a possible alternative to current proposed legislation to levy a broader tax on all stock transfers. A clear, direct statutory structure targeted at reducing speculation and minimizing taxpayer migration to low tax jurisdictions is key to ensuring the success of this tax structure.

I. OVERVIEW: FINANCIAL TRANSACTION AND STOCK TRANSFER TAXES

FTT are taxes levied on the purchase or sale of securities, such as stocks or Exchange-Traded Funds (ETFs), and are collected by

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L.J. 445, 446 (2012) (discussing the impact of the flash crash and resulting regulatory responses).

14. *Id.* at 445.

15. For a discussion of recent calls to action, notably in New York, see *infra* Section III.

a third party facilitating the trade, known as a clearinghouse.[16] FTTs are not a new concept, as financial instruments have been taxed in various forms and at varied rates for hundreds of years,[17] and were often implemented as an attempt to curb speculation in financial markets.[18] A prominent form of FTT is a STT a tax that is assessed when an investor purchases or sells a stock or other covered security.[19] However, the goal of curbing speculation through these taxes is seldom realized, as several financial crises fueled by speculation occurred throughout the twentieth and twenty-first centuries.[20]

A. The United States

The United States maintains two levels of taxation: federal,[21] and state.[22] Within these two systems, there approximately 11,000 unique tax jurisdictions.[23] In addition to the significant number of jurisdictions, the imposition of a tax at either the federal or state levels raises questions of constitutionality, namely implicating the (Dormant) Commerce Clause,[24] Due Process Clause,[25] and the Equal Protection Clause.[26] An analysis of this vast tax landscape

16. Lee Sheppard, *A Tax to Kill High Frequency Trading*, FORBES (Oct. 16, 2012, 12:08 PM) https://www.forbes.com/sites/leesheppard/2012/10/16/a-tax-to-kill-high-frequency-trading/?sh=2858db4d6404 (providing both historical context and a critical view of transactional taxes).

17. Leonard E. Burman et al., *Financial Transaction Taxes in Theory and Practice*, 69 Nat'l TAX J. 171, 174–75 (Mar. 2016) (citing Mark P. Keightley, *A Securities Transaction Tax: Financial Markets and Revenue Effects*, Cong. Research Serv., R41192 (2012) (discussing the various forms and rates in which FTTs were levied in the early-mid 19th century)).

18. *Id.* at 172–74 (citing Joseph Thorndike, *Speculation and Taxation: Time for a Transaction Tax?*, 119 TAX NOTES 1367 (2008) (discussing legislative intent behind FTTs in the U.S.)).

19. *See* Ulrik Boesen, *The Drawback of State Taxes on Financial Transactions*, TAX FOUND. (Jan. 11, 2021) https://taxfoundation.org/state-tax-financial-transactions/#:~:text=A%20financial%20transaction%20tax%20(FTT,and%20lower%20price%20of%20assets (discussing the potential impact transfer taxes may have on states, individuals, and what constitutional issues may arise as a result).

20. *Id.*

21. *See generally* 26 U.S.C. §§ 1–8.

22. *See* U.S. CONST. amend. X.

23. *See* Jared Walczak, *Sales Tax Rates in Major Cities, Midyear 2019,* TAX FOUNDATION (Aug. 14, 2019) https://taxfoundation.org/sales-tax-rates-major-cities-2019/.

24. *See* U.S. CONST. art. I. § 8; *see also* Gibbons v. Ogden, 22 U.S. 1 (1824) (describing the "Dormant Commerce Clause" where states are prohibited from regulating commerce occurring outside of their borders, regardless of whether the statute imposing such a burden facially does so).

25. *See* U.S. CONST. amend. V, XIV.

26. *See* U.S. CONST. amend. XIV.

is beyond the scope of this Article; however, a discussion of FTT and STT at the federal and state levels follows, which will briefly address some of these constitutional concerns as potential limiting factors.

1. The Federal Approach

Although a seemingly new concept, the United States has a long history of FTTs.[27] From 1914–1966 the federal government experimented with different FTT, adjusting rates and application before ultimately abandoning it (to an extent).[28] Beginning in 1914, the FTT rate was .02 percent of par value at sale,[29] then, following a recommendation by the famed economist John Maynard Keynes in 1936,[30] the rate was raised to .04–.06 percent of par value.[31] Following par value manipulation throughout the 1940s and 50s,[32] the federal government changed their approach several times. First, the government set the rate to .04 percent of market value to prevent any initial manipulation; then in 1960, the rate was changed to .10 percent at issuance of the security and .04 percent

27. Burman et al., *supra* note 17 (discussing, *inter alia*, the fact that FTTs have been a part of the United States Tax regime since "the early days of the Republic," until relatively recently).

28. MARK P. KEIGHTLEY, A SECURITIES TRANSACTION TAX: FINANCIAL MARKETS AND REVENUE EFFECTS, CONG. RESEARCH SERV., R41192, at 1–2 (2012) (highlighting the change of rates and assessment of bases as a reaction to various market situations).

29. James Chen, *Par Value*, INVESTOPEDIA (Jan. 31, 2023), https://www.investopedia.com/terms/p/parvalue.asp (defining par value as the value of a stock as provided in a corporation's chartering documents, typically set at a very low rate, and "often unrelated to the actual value of its shares trading on the open market."); *see also* Aaron Katz, *What's the Deal with Par Value? re: Corporate Tax*, NAT'L L.REV. (Feb. 15, 2016) (discussing the importance of par value in the corporate tax context and defining par value as the minimum price per share, typically $.01 or $.001 in modern times).

30. Leonard E. Burnman et al., *Financial Transactions Taxes: An Overview*, Tax Policy Center, URBAN INST. & BROOKINGS INST., at 2 (Jan. 2016), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000587-financial-transaction-taxes.pdf (highlighting Keynes' recommendation to impose a larger FTT following the Great Depression as a way to reduce speculation); *see also* John Maynard Keynes, *The General Theory of Employment, Interest, and Money*, 158–60 (1953).

31. KEIGHTLEY, *supra* note 28.

32. Companies are free to set their par value at whatever price they feel is appropriate, as it is simply a floor for the stock's price (with other implications that are beyond the scope of this paper relating to, for example, franchise taxes or bankruptcy). Companies were, and still are, free to issue no-par value stocks during this time and avoid the FTT, placing the risk of insolvency on unwitting shareholders. This, among other political and economic considerations, was a likely driver of the shift from a par-value based FTT to an eventual issuance-and-market-value system.

at subsequent transfer; and in 1966, the government decided that enough was enough, and took the FTT off of the books.[33]

Although the United States federal government chose to repeal the FTT in 1966,[34] a secondary FTT was enacted as part of the Securities and Exchange Act of 1934,[35] to provide a budget for the Securities and Exchange Commission ("SEC").[36] Seventy years later, to increase revenues to the SEC and reduce the burden on individual investors, the SEC adopted "Section 31", a streamlined manner in which fees are assessed and collected.[37] Typically, this fee is assessed on a semi-annual basis and collected by Self-Regulatory Organizations[38] ("SROs") through fees that are then remitted to the SEC.[39] For 2023, the SEC set the rate to $8.00 per $1,000,000 in sales.[40]

2. State-Level Considerations

New York is the only state in the United States that imposes an FTT.[41] Although the federal government is entitled to tax income through the Sixteenth Amendment, states must utilize a more complex system. To properly levy a tax on an individual's

33. KEIGHTLEY, *supra* note 28; *see, e.g.*, I.R.C. §§ 4301, 4321 (1954).

34. As an effort to reduce taxation and to curb the expansion of the federal government following the Great Depression and mid-century wartime, the FTT was repealed as part of the *Excise Tax Reduction Act of 1965* (P.L. 89-44).

35. *See* 15 USC § 78a et seq. (1934).

36. *Id.* at § 78ee.

37. *See* 17 C.F.R § 240.31 (2022).

38. 15 U.S.C. § 78c(a)(26) (2012) ("The term 'self-regulatory organization' means any national securities exchange, registered securities association, or registered clearing agency[.]").

39. *See* Collection Practices under Section 31 of the Exchange Act, Exchange Release No. 34-49928, 69 Fed. Reg. 41060 at section II(A) (Jul. 7, 2004) (describing the process and procedure for SRO fee collection and remittance).

40. For more information on the 2023 fees, see Press Release, Securities & Exchange Commission, Fee Rate Advisory #2 for Fiscal Year 2023 (Jan. 23, 2023) (describing the initial 2023 fees for SROs), https://www.sec.gov/news/press-release/2023-15; Press Release, Securities & Exchange Commission Fee Rate Advisory #3 for Fiscal Year 2023 (Mar. 1, 2023) (indicating that subject to 15 U.S.C. § 31(j)(2), the SEC will not make mid-year adjustment to the fee established in January 2023), https://www.sec.gov/news/press-release/2022-152.

41. Burman et al., *supra* note 17, at 2–3. A few other states briefly imposed STT in the past; for example, Florida levied a tax on stock certificates until 2002; for more information, see Leon A. Conrad, *Corporations – Stock Transfer Tax,* 15 U. MIAMI L. REV. 434 (1961) Available at: https://repository.law.miami.edu/umlr/vol15/iss4/11 (discussing the since-revoked 1959 Fla. Stat. §§ 21.04–.05 Documentary Stamp Tax); *see also* FLA. S. COMM. ON FIN. & TAX, PCB 2164 (2002) (proposing the revocation of Fla. Stat. § 201.05, highlighting that between 1998 and 2000, the average tax due for the 36 payers that disclosed liability was $4.20).

income or on a transaction, the state must establish sufficient jurisdiction–this is done primarily through the individual's residence or the source of the income.[42]

By way of background, state taxation based on residence is the most straightforward approach, as it is "universally recognized" that the receipt of income within the boundaries of a tax jurisdiction is a taxable event, subject to the rules of that jurisdiction.[43] "Sourcing" is the method by which a state allocates tax burden for non-residents that receive income from within that state,[44] typically analyzed through either an "origin" or a "destination" scheme.[45] In an "origin state," it is permissible for a jurisdiction to tax a seller as the "originator" of the transaction; in contrast, a "destination state" is one where the state may tax the payment through the location of the buyer–in either case, the buyer or the seller are the foundation for taxing jurisdiction.[46] As of 2018, 11 of the 50 states utilize an origin-based system (of those, California is a mixed-approach state); the remaining 39 are destination-based.[47]

In addition to these primary jurisdictional inquiries, the question of whether "mere economic presence" is sufficient for a state to assert tax jurisdiction must be considered.[48] In *Bellas Hess v. Department of Revenue*[49] and *Quill Corp v. North Dakota*,[50] the United States Supreme Court held that in order for a state to

42. John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 344–45 (2003), https://scholarship.law.wm.edu/wmlr/vol45/iss1/5 (discussing various aspects of state-level taxation, and highlighting the varied approaches available to states as justified through precedent).

43. *Id.*; *see* New York *ex rel.* Cohn v. Graves, 300 U.S. 308, 312–13 (1932).

44. *See* Schaffer v. Carter, 252 U.S. 37, 52 (1920); *see also* Swain, *supra* note 42 at 345 ("The fundamental rationale for allowing states to tax income with an in-state source is that the state provides benefits and protections that allow the income to arise in the first instance.") (citing JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION 16.07, ¶ 6.04 (3d ed. 1998 & Supp. 2002)). For more information, *see* Hellerstein n.93–94 ¶ 6.04 (2020).

45. *See* Jared Walczak and Janelle Fritts, *State Sales Tax in the Post-Wayfair Era*, TAXFOUNDATION (Dec. 12, 2019), https://taxfoundation.org/state-remote-sales-tax-collection-wayfair/.

46. *Id.* (generally defining the origin-based framework and stating which states are implicated).

47. *Id.* (generally defining the destination-based framework and stating which states are implicated).

48. Swain, *supra* note 42, at 321.

49. 386 U.S. 753 (1967).

50. 504 U.S. 298 (1992).

impose a sale or use tax, and not violate the Dormant Commerce Clause, physical presence is required in that state.[51]

Just ten years later, the Supreme Court in *Complete Auto Transit, Inc. v. Brady*[52] created a four-prong test to determine if interstate taxes violate the Commerce Clause. Through the *Complete Auto* test, a tax passes Commerce Clause muster if it (1) "is applied to an activity with a substantial nexus with the taxing State," (2) "is fairly apportioned," (3) "does not discriminate against interstate commerce," and (4) "is fairly related to the services provided by the State."[53] By creating this test, the Court marked a significant departure from the prior cases, but did not directly overrule them.[54] In effect, *Complete Auto Transit* is a practical approach "grounded in 'economic realities'" that reflect the modern age.[55]

In 2018, after years of trial and error at various state levels, the United States Supreme Court took *Complete Auto Transit* one step further in *South Dakota v. Wayfair, Inc.*,[56] formally overturning the physical presence standard in *Bellas Hess* and *Quill* as it relates to sales tax.[57] This means that a state no longer is limited to jurisdiction based on where the taxpayer or transaction occurs, but whether or not there is sufficient nexus, i.e., economic connection, with the state to justify the tax. While the *Wayfair* ruling may be limited to state sales taxes, this change in the Court's approach to the Commerce Clause will likely have

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51. *Id.* at 309–19.

52. 430 U.S. 274 (1977).

53. *Complete Auto*, 430 U.S. at 279; *see also* Chris Atkins, *Important Tax Cases:* Complete Auto Transit v. Brady *and the Constitutional Limits on State Tax Authority*, TAX FOUND. (May 19, 2005), https://taxfoundation.org/important-tax-cases-complete-auto-transit-v-brady-and-constitutional-limits-state-tax-authority (discussing the impact that *Complete Auto Transit* has on the constitutionality of state-level taxation).

54. *See* Walter Hellerstein, Michael McIntyre, & Richard Pomp, *Commerce Clause Restraints on State Taxation After* Jefferson Lines, 51 TAX L. REV. 47, 49 (1995) (highlighting the influence that *Complete Auto Transit* has on the approach the Supreme Court takes when considering interstate taxation).

55. *Id.* (indicating that "the Court has invoked *Complete Auto's* four-part test in most subsequent Commerce Clause challenges to state taxation") (internal citations omitted)).

56. 138 S. Ct. 2080 (2018).

57. *See Wayfair*, 138 S. Ct. at 2805 (elaborating on the *Complete Auto Transit* case that side-stepped the Court's prior *Quill Corp. v. North Dakota* "physical presence" requirement for a state to be able to impose a *sales* tax on an individual or entity, for a much broader "substantial nexus" requirement).

far-reaching consequences for future tax planning at the state level, potentially including any FTT.[58]

3. New York

In 1905, New York City enacted its first FTT through New York Tax Law § 270,[59] imposing a tax of 1.25 cents per purchase or sale of a stock less than $5, up to 5 cents per stock worth $20 or more.[60] This tax was imposed "based on where the trade is executed . . . and buyer and seller [jointly] share responsibility for ensuring the tax is paid[.]"[61] Expectedly, this new tax came under immediate security on the Constitutional level; first, under the Fourteenth Amendment in *New York ex. rel. Hatch v. Reardon, Peace Officer of the County of New York*,[62] and then under the Commerce Clause in *O'Kane v. New York*,[63] with New York prevailing on both fronts.

In 1968, though, New York City amended its STT to impose additional taxes on "out-of-state" transactions while reducing rates for in-state transactions.[64] This treatment was challenged in U.S.

58. Sarah Horn et al., *Supreme Court Abandons Physical Presence Standard: An In-Depth Look at* South Dakota v. Wayfair, THOMPSON REUTERS TAX CHECKPOINT (June 22, 2018), https://tax.thomsonreuters.com/blog/supreme-court-abandons-physical-presence-standard-an-in-depth-look-at-south-dakota-v-wayfair/ (discussing the *Wayfair* case in light of past caselaw and modern trends and providing some practical takeaways for both states and companies).

59. *See* Boston Stock Exchange et al. v. State Tax Comm'n, 429 U.S. 318, 319 (1977) (holding as unconstitutional an amendment to New York's STT that imposed a greater tax burden on out-of-state transactions, as that violates the Commerce Clause).

60. *Stock Transfer Tax,* N.Y. STATE DEP'T OF TAX'N & FIN., https://www.tax.ny.gov/bus/stock/stktridx.htm (last visited July 24, 2023).

61. David Friedfel, *Don't Bring Back the Stock Transfer Tax*, CITY & STATE NEW YORK (Oct. 22, 2020), https://www.cityandstateny.com/articles/opinion/opinion/dont-bring-back-stock-transfer-tax.html; *see* New York TSB-M-81, *Stock Transfer Tax: Rebates of Stock Transfer Tax* (Oct. 1981).

62. 204 U.S. 152, 157–59 (1907) (holding that the § 270 tax does not violate the Fourteenth Amendment, i.e., the Equal Protection Clause, even though the parties petitioned on those grounds but argued Commerce Clause concerns. As Justice Holmes eloquently stated: "You cannot have a stamp act without something that can be stamped conveniently. And it is easy to contend that justice and equality [cannot] be measured by the convenience of the taxing power. Yet the economists do not condemn stamp acts, and neither does the Constitution.").

63. 283 N.Y. 439, 448-49 (1940) (holding that the § 270 tax does not violate the Commerce Clause).

64. As framed in *Boston Stock Exchange*, this aggressive move by New York may have been the impetus for building the famous "blue room" on 20 Broad Street in New York City, which dramatically expanded the trading floor and profitability of the exchange. For more information, see Archive of the New York Stock Exchange Web Page May 26, 2007, LIBR. OF CONG., https://www.loc.gov/rr/business/hottopic/nyse_current%20building.txt; for an

Supreme Court in *Boston Stock Exchange et al. v. State Tax Comm'n* in 1977, where the Court found that this change violated the (Dormant) Commerce Clause because the tax unfairly prejudiced out-of-state investors.[65]

In 1975, New York City was struggling to stay afloat financially.[66] At the time, the city utilized income from the STT and sales of municipal bonds to finance their municipal activities. Even with these revenue streams, finances at the city level suffered. As a result, the state stepped in and took over, creating the Municipal Assistance Corporation (MAC), which oversaw the municipal funds for the city.[67] Until 1975, New York City managed all of their sales and stock transfer taxes separately from the state, but following the creation of the MAC, the state legislature passed laws converting these city-level taxes to state taxes, to be allocated based on the legislature's own decision making.[68]

At the same time, the U.S. Congress enacted the Federal Securities Acts of 1975 ("1975 Act"),[69] with § 21(2)(d) specifically targeting these New York STTs.[70] The intention behind this legislation was to "remove barriers to competition" through varied reforms. By developing market systems, the 1975 Act streamlined the SEC's authority over companies in the exchanges, regulated

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image of the "blue room" at the time of construction, see NYSE (@NYSE), TWITTER (Jul. 7, 2014, 11:51 AM), https://twitter.com/NYSE/status/486175777554464768.

65. The Federal Securities Acts of 1975 have been codified in 15 U.S.C.A. § 77(bb) (2011), and in pertinent part, § 77(bb)(d), *Physical location of facilities of registered clearing agencies or registered transfer agents not to subject changes in beneficial or record ownership of securities to State or local taxes*. *See also* Boston Stock Exchange et al. v. State Tax Comm'n, 429 U.S. 318, 330 (1977).

66. *See* Roger Dunstan, Cal. Research Bureau, *Overview of New York City's Financial Crisis*, 1 CRB NOTE 3, 1 (Mar. 1, 1995); *see also* Staff of S.E.C., 95th Cong., *Transactions in Securities of the City OF New York* (1977), http://www.sec.gov/info/municipal /staffreport0877.pdf; Staff of J. Econ. Comm., 94th Cong., *New York City's Financial Crisis: An Evaluation of Its Economic Impact and OF Proposed Policy Solutions* (1975) (prepared by Ralph Schlosstein), available at https://www.jec.senate.gov/reports/94th%20Congress /Other%20Reports/New%20York%20City's%20Financial%20Crisis%20(715).pdf.

67. *See* Roger Dunstan, Cal. Research Bureau, *Overview of New York City's Financial Crisis*, 1 CRB NOTE 3, 1 (Mar. 1, 1995); *see also* Staff of S.E.C., 95th Cong., *Transactions in Securities of the City OF New York* (1977); Staff of J. Econ. Comm., 94th Cong., *New York City's Financial Crisis: An Evaluation of Its Economic Impact and OF Proposed Policy Solutions* (1975) (prepared by Ralph Schlosstein).

68. *See* Roger Dunstan, Cal. Research Bureau, *Overview of New York City's Financial Crisis*, 1 CRB NOTE 3, 1 (Mar. 1, 1995); *see also* Staff of S.E.C., 95th Cong., *Transactions in Securities of the City OF New York* (1977); Staff of J. Econ. Comm., 94th Cong., *New York City's Financial Crisis: An Evaluation of Its Economic Impact and OF Proposed Policy Solutions* (1975) (prepared by Ralph Schlosstein).

69. Securities Act Amendments of 1975, Pub. L. No. 94–29, 80 STAT. 97 (1975).

70. *Boston Stock Exchange*, 429 U.S. at nn.3–4.

municipalities, and the collection of information.[71] The 1975 Act further preempts states or other localities from imposing a tax on stock transfers if the *only* jurisdictional basis for nexus is the fact that the clearinghouse processing the transaction is within that state.[72]

Following the Federal Securities Acts of 1975 and *Boston Stock Exchange* case, New York *partially* phased out the initial STT. To replace this system, New York enacted an elective 100% STT tax rebate through tax stamps in 1981.[73] These rebates were elective, and included an obligation to first purchase the stamps, then to submit them following each transaction. Notably, the STT could not be fully phased out as the proceeds from the purchase of the 1981-type stamps funded existing MAC bonds, rather than directly going toward municipal projects.[74] In practice, these stamps are not purchased contemporaneously with trading individual stocks on the trader level. Rather, a stock purchase clearinghouse, like the Depository Trust and Clearing Corporation,[75] would purchase the stamps and utilize them on

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71. Securities Act Amendments of 1975, *supra* note 69, at 97.

72. The plain language of the 1975 Act seems to support the ultimate conclusion of *Quill*, in that physical presence may be required; however, this has yet to be seen in light of *Wayfair*. In pertinent part, 15 U.S.C.A. § 78bb(d) states:

> "No State … shall impose any tax on any change in beneficial or record ownership of securities effected through the facilities of a registered clearing agency … unless such change in beneficial or record ownership or such transfer or delivery or receipt would otherwise be taxable by such State … if the facilities of such registered clearing agency, registered transfer agent, or any nominee thereof or custodian therefor were not physically located in the taxing State[]. No State … shall impose any tax on securities which are deposited in or retained by a registered clearing agency … unless such securities would otherwise be taxable by such State … if the facilities of such registered clearing agency, registered transfer agent, or any nominee thereof or custodian therefor were not physically located in the taxing State []."

For example, if New York imposes a stock transfer tax on a stock transfer between A, an individual residing and domiciled in Delaware, and B, a corporation that is chartered and operating fully in New York, with clearinghouse C located in and processing the transaction in New York, § 78(bb)(d) would not apply, as corporation B is located in New York, placing sufficient nexus between the state and the transaction, aside from the clearinghouse. However, taking the same facts and changing corporation B to a Delaware Corporation with *no ties to New York whatsoever*, New York (or any other state) would be precluded from imposing a tax on this transaction, as clearinghouse C is the only connection between the transaction and the state providing nexus.

73. New York State Department (2020), *infra* note 143.

74. David S. Miller, Esq., *Letter to The Honorable David Paterson Re: New York Stock Transfer Tax* (Nov. 4, 2008), https://nysba.org/app/uploads/2020/03/1167-Letter.pdf.

75. Campbell R. Harvey, *Glossary: Depository Trust and Clearing Corporation (DTCC)*, *NASDAQ* (2018) https://www.nasdaq.com/glossary/d/depository-trust-and-clearing-corporation.

behalf of the trader, as clearinghouses receive a 100% rebate "without having to actually file rebate claims."[76] As of 2008, the MAC bonds were retired, and numerous tax practitioners, the New York Bar Association Executive Committee, and New York Bar Tax Section formally endorsed the repeal of the STT, as the municipal bonds they supported were no longer in place.[77]

Even with the existing constitutional issues, preemption concerns, and recommendations by tax practitioners, New York still retains the STT and 100% rebate system. Given that New York is the only state that maintains an FTT/STT in the United States, practitioners and investors alike are pushing to have the state apply it to certain transactions or remove it entirely.[78]

B. The European Approach

While several European nations levy FTTs,[79] this article will review the approaches of France, the United Kingdom, and Sweden.[80] Each of these countries implemented some version of an FTT with limited success, varying from a complete reversal to an amended approach.[81] In 2013, the European Commission (EC) published a working document that outlined several approaches to an FTT, including "implementation, monitoring, and evaluation."[82] While the EC's report found support in major economies, the negotiations fell apart, with only a handful of nations still in talks regarding a common scheme.[83] While a discussion regarding a potential common system establishing FTTs in Europe is beyond the scope of this article, an analysis of three exemplary nations proves illustrative.

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76. Letter from Hon. Robert L. Megna, Comm'r of Dept. of Tax'n and Fin., and Daniel Smirlock, Deputy Comm'r of Dept. of Tax'n and Fi., to Hon. David Paterson, Governor of the State of N.Y. (Nov. 4, 2008).

77. *Id.*

78. For a discussion of specific proposed legislation, see *infra*, Section IV.

79. Elke Asen, *Financial Transaction Taxes in Europe*, TAX FOUND. (Feb. 4, 2021), https://taxfoundation.org/financial-transaction-taxes-europe-2021/ ("Belgium, Finland, France, Ireland, Italy, Poland, Spain, Switzerland, Turkey, and the United Kingdom[.]").

80. Burman, et al., *supra* note 17, at 176, 178 (discussing the varied applications and impacts that FTT's have in the G-20, highlighting the U.K., France, and Switzerland).

81. *Id.*

82. For more information, see European Commission, *Impact Assessment: Proposal for a [Council] Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, European Commission Working Document No. 28 (Brussels, 2013).

83. *See* Asen, *supra* note 79.

1. France

In 2012, the French government implemented wide-sweeping FTT[84] as a reaction to the finance sector's role in the 2008 economic crisis.[85] This tax applies to stocks issued by domestic French companies with a market capitalization of more than €1 billion.[86] The 2012 French tax also applies to all stocks traded, regardless of whether the transaction occurred within the French borders.[87] Additionally, the French system imposes a separate tax on high frequency trading (HFT).[88] A detailed, statistical study conducted on the impact of the French tax indicated year-over-year, trading volume decreased by 14–20%, and that alternative approaches to the end-goal of reparations could be considered.[89] The intention of these reparations was to return profits from large corporations to those individuals impacted by the dangerous banking practices employed in the 2008 financial crisis. The authors indicated that a limitation to their study was the ability to separate HFT from the rest of the market but indicated that since it was taxed at a lower rate; even so, it is unlikely that the HFT tax had a significant impact on the overall market.[90]

As related to the United States, the French system is differentiated on three grounds: (1) the tax applies to all transactions, (2) there are safe-harbors and varied levels of tax rates, and (3) the government imposed these taxes as a form of reparation for the financial sector's involvement in the 2008 crisis.[91] France is further differentiated in that the investment service provider (ISP) that *initiates* the trade bear the burden of collecting and remitting the tax, regardless of how many ISP are involved, while clearinghouses (so long as it is not an investment for themselves) are exempt from the tax.[92] Although it has the

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84. The French Tax Code, Art. 235 ter ZD, Title 3, Ch. 3, § 3.

85. Stephan Meyer, Martin Wagner & Christof Weinhardt, *Politically Motivated Taxes in Financial Markets: The Case of the French Financial Transaction Tax*, 47 J. FIN. SERV. RSCH. 177, 177–78 (2015).

86. *Id.* at 179.

87. Burman et al., *supra* note 17, at 181.

88. *See* BLOOMBERG LAW: TAX, COUNTRY GUIDES, France, § 10.2.

89. Meyer, Wagner & Weinhardt, *supra* note 85, at 201.

90. *Id.*

91. *Id.* at 180.

92. Bulletin Officiel des Finances Publiques [Official Bulletin of Public Finances], *TCA – Tax on the Acquisition of Equity or Similar Securities – Methods of* Taxation, https://bofip.impots.gouv.fr/bofip/7575-PGP.html/identifiant=BOI-TCA-FIN-10-30-20140115.

same net effect, this approach places the burden on the investor's agent, rather than the organization that is simply completing the order as requested.

As discussed in Section A.2 above, the FTT and STT in the United States were created proactively and to create a barrier to entry for those speculators intent on entering the market.

2. The United Kingdom

In 1694, the United Kingdom (U.K.) implemented one of the first examples of a FTT, with the "British Stamp Duty."[93] This same duty carries to this day, with modern updates in 1986 codifying a tax on the transfer of common stocks and omitting derivatives like futures and options.[94] Additionally, these taxes apply to "both primary and secondary market transactions," where "the issuer [of new stock] pays the initial tax," and in secondary markets, where "the purchaser pays the tax."[95] Additionally, although stock repurchases are considered secondary market transactions, corporations are taxed as purchasers.[96] As of the time of writing, the Stamp Duty in the U.K. is set at 0.5 percent on the transfer of shares.[97] Since the London Stock exchange is an international hub for financial activity, the U.K. chose to impose this tax when legal ownership of UK-based shares is transferred, regardless of origin, to avoid distinguishing between foreign and domestic activity.[98] Transactions that occur through intermediaries that (effectively) assign beneficial ownership, or are exchanged on behalf of the actual owner on other exchanges, are taxable at three-times the ordinary rate.[99]

Since the tax is levied at the point of registration, creative financiers created entities to conduct this business, known as "active nominees," and even "bearer instruments," which are both taxable at a treble rate, or triple the value of the base fine.[100] Additionally, since the U.K. structure encourages investors to use

93. Campbell & Froot, *supra* note 9, at 11.
94. *Id.*
95. *Id.*
96. *Id.*
97. *See* Bloomberg Law: Tax, Country Guides, United Kingdom, § 9.4.
98. Campbell & Froot, *supra* note 9, at 12.
99. *Id.* at 13.
100. *Id.* at 12–13.

derivative investments, this tax drives investors to use riskier, speculative investments to avoid taxation.[101]

When compared to the United States, the U.K. approach is distinguishable in several regards, notably: (1) the U.K. approach differentiates between common stock and derivatives, (2) imposes higher rates for intermediary clearinghouses, and (3) similar to the French system discussed in Section B.1, does not distinguish between foreign and domestic trading, as the tax is levied at the point of registration.[102]

3. Sweden

Seemingly taking notes from the U.S., France, and U.K., Sweden imposed FTTs beginning in 1984 and repealed them in 1991.[103] This FTT was similar to the French and U.K. approach in that it was levied on both the purchase and sale of equities, but included derivatives, at a rate of 0.5 percent each; and was similar to the U.S. in that the tax only applied to transactions flowing through Swedish firms and brokers.[104] Unlike the other examples presented, Sweden also taxed fixed-income securities, a move that decreased trading volume in those securities by approximately eighty percent.[105] This mixed approach led to significant issues with financial transaction migration, and at its lowest point, trading volume was down forty-eight percent, with a seventy-eight percent decrease in Ericsson securities trading volume alone, Sweden's most actively traded company.[106] In 1992, following the repeal of the tax regime, trading volume increased significantly.[107]

The failure of the Swedish FTT serves as an example of a country trying to do too much too fast and highlights the importance of understanding both the market and the jurisdiction's needs. This article attempts to suggest an efficient and fair solution to the current calls for FTT/STT in the U.S., taking into consideration the successes and failures of foreign governments, and the unique nature of the U.S. Constitutional and tax regime implications.

101. *Id.* at 14.
102. *Id.* at 12–14.
103. Burman et al., *supra* note 17, at 178.
104. *Id.*; *see also* Campbell & Froot, *supra* note 9, at 4–5.
105. Campbell & Froot, *supra* note 9, at 6.
106. *Id.*
107. *Id.* at 7–9.

II. HIGH FREQUENCY TRADING

In 2010, the SEC deemed HFTs to be one of the "most significant market structure developments" in recent financial history.[108] Although the term is colloquially used to describe institutional trading at high speeds, the SEC provides some characteristics that may help to identify HFT, including sophisticated computer software, individual data feeds, rapid liquidation of positions, submission-cancellation schemes, and low margin.[109] Since HFT is a new phenomenon, little research exists as to the impact that tax regimes may have on their operations; even so, the SEC has made some initial assessments of their current impact on the market.[110] Moore's Law, the premise that technology develops exponentially, is highlighted in the financial world, as HFT has developed alongside computer software and the advent of high-speed internet.[111]

A. Flash Crashes

In certain instances, HFT may exacerbate potential financial disasters, "flash crashes," or sudden decreases in liquidity and market value, followed by a return to the previous level.[112] While several flash crashes have occurred in the history of global financial markets, the most prevalent and studied is the Flash Crash of 2010.[113] In a sweeping analysis of the 2010 Flash Crash, the chief economist at the Commodity Futures Trading Commission, Andrei Kirilenko, along with other scholars, concluded that while HFT was not the impetus for the Flash Crash, it was a significant factor in the acceleration of the market conditions.[114] Through Kirilenko's analysis of the role that HFT

108. *See* Concept Release on Equity Market Structure, Exchange Act Release No. 34-61358, 75 Fed. Reg. 3594, 3606 (Jan. 21, 2010).

109. *Id.*

110. U.S. S.E.C. Division of Trading and Markets, *Equity Market Structure Literature Review Part II: High Frequency Trading. U.S. Securities and Exchange Commission* (Mar. 18, 2014).

111. *Id.*; *see also* Gaetano, *supra* note 12 (Gaetano cites a study by the U.K. trade commission that found twenty-two percent of trading done on the London Stock Exchange competed to fill a trade in less than eighty-one millionths of a second.).

112. Andrei Kirilenko et al., *The Flash Crash: The Impact of High-Frequency Trading on an Electronic Market*, 72 J. OF FIN. 3, at 967–98 (Jan. 25, 2017), https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_flashcrash0314.pdf.

113. *Id.*

114. *Id.*

plays in finding market equilibrium and risk-sharing, one central theme came through clearly when read through the lens of a retail investor, "the [HFT] industry profits at the expense of other traders, . . . [and] could force smaller traders into other markets."[115] Since HFT firms mainly base their competitive advantage on technology, a race-to-the-bottom exists: those who are able to find arbitrage opportunities the fastest are able to profit, while retail investors are caught in the crossfire of ever-shrinking bid-ask spreads.[116]

The fallout from the 2010 Flash Crash made its way to Capitol Hill, where Congress held several hearings to identify the cause of this, and other financial disasters.[117] These hearings uncovered the accelerating nature of HFT, legislation taxing HFT was subsequently proposed,[118] but was eventually trapped and ended in Congressional and Senate Committees.[119] Although these committees have public hearings, it is likely the case that industry lobbyists have a significant influence on the ultimate outcome, outshining the concerns of main street investors. Highlighting this issue, from 1998 through 2016, financial institutions spent approximately $7.5 billion in lobbying expenses in an attempt to secure favorable rules and regulations.[120] Since 2010, several members of Congress, industry leaders, and practitioners have called for regulation or barriers to entry into HFT due to their dangerous potential to cause accelerated financial crises.[121]

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115. Citizens for Responsibility and Ethics in Washington, *Rise of the Machines*, https://www.citizensforethics.org/hftraders (May 13, 2013).

116. *See* Akhilesh Ganti et al., *Bid-Ask Spread*, INVESTOPEDIA (Aug. 30, 2021), https://www.investopedia.com/terms/b/bid-askspread.asp (defining bid-ask spread as "essentially the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept.").

117. *Id.* at 3 (citing Transcript, CQ Transcriptions, *Rep. Paul Kanjorski Holds a Hearing on the Stock Market Plunge*, May 11, 2010.).

118. Citizens, *supra* note 115, at 3 (citing Memo, Office of Rep. Peter DeFazio, *Joint Tax Committee Finds Harkin, DeFazio Wall Street Trading and Speculators Tax Generates More Than $350 Billion*, (Nov. 7, 2011), https://defazio.house.gov/media-center/press-releases/memo-joint-tax-committee-finds-harkin-defazio-wall-street-trading-and).

119. Citizens, *supra* note 115, at 3 (discussing the demise of the *Wall Street Trading and Speculators Tax Act*, which proposed a .03 percent tax on all trades. H.R. 3313, 112th Congress).

120. *See* Deniz Igan and Thomas Lambert, *IMF Working Paper – Bank Lobbying: Regulatory Capture and Beyond*, WP/19/171, IMF (Aug. 2019), https://www.imf.org/-/media/Files/Publications/WP/2019/wpiea2019171-print-pdf.ashx.

121. Citizens, *supra* note 115, at 3–5.

B. Latency and Innovation

A key aspect to the success of HFT in both the United States and abroad is the ability to minimize latency, or the "time delay for receiving, analyzing, and transmitting information and orders."[122] To achieve this goal, HFT companies invest in physical improvements, such as specialized fiber-optic cables and contract with Internet service providers for the highest bandwidth possible;[123] additionally, these firms attempt to be as close to the exchange as possible, or "collocate," in order to minimize the length of the cable from their computer or office to the exchange, reducing the time it takes for the trade to travel between the exchange and the firm.[124]

While a direct, physical connection to the exchange is helpful, these physical improvements are not valuable to firms that are unable to execute trades at high speed.[125] The term of art used in the HFT industry is "differentiation," or the ability for an algorithm to identify and respond to ever-changing market conditions.[126] As more firms enter into the HFT market, firms are required to innovate at dramatic rates, reducing testing time and increasing the chances of major error–a potentially devastating outcome for financial markets.[127]

Firms that are successful in minimizing latency and optimizing their algorithms enjoy great success for themselves and their investors;[128] however, this arbitrage of time and resources has an adverse effect on the market, costing traditional investors

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122. Lindsey C. Crump, *Regulating to Achieve Stability in the Domain of High-Frequency Trading*, 22 MICH. TELECOMM. & TECH. L. REV. 161, 164 (2015).

123. *Id.* at 165 & nn.17–19. (discussing the capital investment involved in creating such elaborate systems and the potential impact of experimental technology).

124. *Id.*; *see also* Tom Groenfedlt, *HFN Offers the Fastest Data Feeds — From Mahwah*, FORBES (Nov. 4, 2013, 9:55 AM) https://www.forbes.com/sites/tomgroenfeldt/2013/11/04/hfn-offers-the-fastest-data-feeds-from-mahwah/?sh=3c55f76178bb.

125. Crump, *supra* note 122, at 164–65.

126. *Id.* at 165.

127. *Id.* at 165 and n.22 (citing SEC, *Investor Bulletin: New Measures to Address Market Volatility* (2013), http://www.sec.gov/investor/alerts/circuitbreakersbulletin.htm) (highlighting a rather rudimentary fail-safe used by some firms, a circuit breaker to shut off traders that may encounter errors).

128. *See* Michael Kearns, Alex Kulesza, & Yuriy Nayaka, *Empirical Limitations on High Frequency Trading Profitability*, 2010 J. TRADING 1, 3 (noting that some companies provide that HFT profitability may range from $8.5–25 billion annually but concluding that the number is likely closer to $3.4 billion).

"as much as $5 billion per year"[129] due to decreased market liquidity and narrow margins.[130]

III. ANALYSIS: CALLS FOR MODERN U.S. LEGISLATION

Following the rise of the Occupy Wall Street Movement,[131] several swings in the global financial markets over the past twenty years,[132] and various other political developments,[133] renewed calls for STT are heard throughout the United States, and abroad. While these developments and political movements are outside of the scope of this Article, they serve as an important backdrop for the current federal and state-level calls for financial taxes, as well as the response coming from the financial sector.

129. Michael Sheetz*, High-Speed Traders Cost Regular Investors Almost $5 Billion a Year, Study Says*, CNBC (Jan. 27, 2020, 1:57 PM), https://www.cnbc.com/2020/01/27/latency-arbitrage-trading-costs-investors-5-billion-a-year-study.html.

130. As a result of high frequency traders' dramatic speed through physical connections to the exchange and well-crafted algorithms, sellers likely do not have to "aggressively" price their sales, as these algorithms are able to identify areas of opportunity and execute within "79 milliseconds" and win over 80 percent of the time. While profitable for the individual HFT firms, this arbitrage reduces overall market liquidity and marketability, costing retail investors trillions. *Id.* (citing Matteo Aquilina, Eric Budish & Peter O'Neil, *Quantifying the High-Frequency Trading "Arms Race": A Simple New Methodology and Estimates*, UNITED KINGDOM FINANCIAL CONDUCT AUTHORITY OCCASIONAL PAPER 50, 21 (Jan. 2020), https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-50-quantifying-high-frequency-trading-arms-race-new-methodology).

131. The Occupy Wall Street movement was a reaction to the Great Recession of 2008 that began in New York City and spread across the United States; the main points of concern for this movement were bank bailouts and record high unemployment rates. For more information on the Occupy Wall Street movement, and the timeline of events, see Jared Wade, *Occupy Wall Street* [*Timeline*], 1 NAT'L LAW REV. 280 (Oct. 7, 2011), https://www.natlawreview.com/article/occupy-wall-street-time-line.

132. *See* Sean Ross, *3 Financial Crises in the 21st Century*, INVESTOPEDIA (Mar. 27, 2023), https://www.investopedia.com/articles/investing/011116/3-financial-crises-21st-century.asp (discussing three major financial crises, one in Argentina, another in the United States, and ending on the most recent Russian financial crisis); *see also* THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, FCIC (2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (discussing the financial products and circumstances that led to varied financial crises that plagued the United States throughout the 21st century).

133. For a political and technical analysis of financial crises and their impact on the United States political system, see Jeffry Frieden, et al., ECONOMIC CRISES AND POLITICAL CHANGE IN THE UNITED STATES, 1900 TO THE PRESENT (May 2017), https://scholar.harvard.edu/files/jfrieden/files/economic_crisis_and_political_change_complete.pdf.

A. The New York Stock Transfer Tax Plan of 2021

In 2021, the New York legislature proposed several variants on a Stock Transfer Tax Plan ("STTP"), notably in Bill A7791B.[134] A7791B proposes to repeal a state rebate provided for the stock transfer tax and to put those funds first to the "state General Fund" up to $3 billion annually (for two years), then to municipal expenses (public transport, water systems, etc.) after paying the MAC bond debtholders.[135] These rebates work in the same manner as those in place today, where a clearinghouse receives a 100 percent rebate for all stock transfers they process.[136] The MAC Bonds are also in place to support municipal projects throughout the city, and were created to ensure that the city had a steady stream of funds to do so.[137] However, in addition to the bonds themselves expiring, the MAC bond project also recently sunset, requiring the legislature to find ways to continue funding their projects. The sponsors of this new proposal argue that because the STT is "on the books," it would help to shore up debts and generate revenues for the state with minimal administrative costs.[138]

This seems to be in direct response to the concerns that these financial transactions taxes are no longer needed, as the MAC bonds which were initially enacted to meet those same goals, are now expired.[139] This argument falls short, though, because the MAC bonds were simply a solution created by New York (state) to fund the corporation which managed the city on the state's behalf.[140] The proposed legislation would meet the same goals as the MAC as soon as 2023 by automatically distributing funds to ten distinct groups, such as safe water, mass-transportation, clean energy research, and housing.[141]

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134. Assemb. B. A7791B (N.Y. 2021).

135. *Id.*

136. For additional information on the development and intention behind MAC Bonds, *see* Section 1.A.3.

137. For additional information on the retirement of the MAC project, see *supra* note 77.

138. Donna Borak, *New York Financial Heavyweights Attack Stock Transfer Tax Plan*, BLOOMBERG LAW: TAX (Feb. 3, 2021, 2:07 PM), https://news.bloombergtax.com/daily-tax-report-state/wall-street-fights-back-efforts-to-revive-stock-transfer-tax. (quoting NY Assembly Member Phil Steck, "It's not a tax on Wall Street . . . [i]t's just collected by Wall Street.").

139. *See* Miller, *supra* note 74, at 2–3.

140. *Id.*

141. Assemb. B. A7791B §§ 3(i)–(x).

One of the key aspects of this legislation is the complete repeal of New York's Tax Law Section 280-A,[142] which is the operative language in the state statute providing the elective rebate for the state-level stock transfer tax paid.[143] However, the language in the statute that permits the state to collect this tax is vague and leads to double-liability for the same investment dollar:

> "It shall be the duty of the person or persons making or effectuating the sale or transfer, including the person or persons to whom the sale or transfer is made, to pay the tax provided by this article; provided, however, that this subdivision shall not apply to any sale or transfer wherein the vendor or transferor is a governmental entity or international organization which is not subject to the tax."[144]

Therefore, if investor A purchases a stock from broker B, it is both A and B's duty to pay the tax; yet the statute is only enforceable against "tax agents or brokers," with the penalty of a misdemeanor, a fine of up to $1,000 and/or imprisonment for up to six months.[145] This imprecise language, while not a concern at the moment due to the rebate structure, will lead to significant liability concerns as to which party bears the incidence of the tax, and may lead to increased investment costs on the part of the investor should it be removed without this issue addressed.

The state legislators proposing A7791 also include the following language as a final note, likely intended to clear up questions as to who is within the purview of this tax:

> "[A] transaction referred to in subdivision one of this section is subject to tax if any activity in furtherance of the transaction *occurs within the state* or if a party involved in the transaction satisfies *nexus* with New York state which shall be defined as

142. *Id.* at § 1.

143. The operative language can be found in §§ 280-A(1) and (3), which state:
[A]ll of the amount of tax incurred and paid shall be allowed as a rebate on transactions subject to the stock transfer tax occurring on and after October first, nineteen hundred eighty-one," and "rebates may be paid only upon the filing of a claim for rebate with the state tax commission. All claims for rebate shall be presented in such form and contain such information as the state tax commission, by rule, regulation or instruction, shall prescribe and shall be presented within two years after the affixing and cancelling of stock transfer tax stamps or payment of the tax otherwise than by the use of stamps."

144. N.Y. Tax L. § 270 (McKinney 1997).

145. N.Y. Tax L. § 272 (2012).

> broadly as is permitted under the United States Constitution."[146]

Accordingly, the proposed legislation appears to be both responsive to recent cases that established a nexus standard,[147] and potentially forward-looking to potential concerns that may arise; however, the legislature does not specifically characterize the tax. Various definitions explain the nature of the tax, be it a progressive or regressive tax,[148] but fail to specifically state whether a financial transactions or stock transfer tax is *a sales tax*. This distinction is essential, as the *Wayfair* decision, which expands the *Complete Auto* economic nexus to sales taxes,[149] may not apply, and a physical presence nexus would be required.[150] While a sales tax may be implied by the use of the term "nexus" in the statute,[151] the New York legislature can avoid future complications by specifying that it is a sales tax. The legislature could further bolster this designation by stating that a STT is essentially a sales tax, given that one individual is selling their stake in the company to another through a clearing house. Then, by combining this practical explanation and clarifying the language of the statute, the legislature can avoid these concerns.

Although the language of the proposed legislation is unclear, New York Assembly Member Phillip Steck and New York State Senator James Sanders published a joint press release where it was made clear that the proposed legislation is "a sales tax of 5 cents per $100 on the sale of stock . . . paid not by purchasers of stock, most of whom do not live in New York State[.]"[152] Yet, later

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146. Assemb. B. A7791B § 9 (emphasis added).

147. *See* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (2018); *see also* South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018).

148. *See* Julia Kagan & Lea D. Uradu, *Transfer Tax*, INVESTOPEDIA (Dec. 15, 2022), https://www.investopedia.com/terms/t/transfertax.asp (defining transfer taxes as a tax "charge levied on the transfer of ownership or title to property from one individual or entity to another"); *see also* Aaron Klein, *What is a financial transaction tax?*, BROOKINGS INST, POL'Y 2020 (Mar. 27, 2020), https://www.brookings.edu/policy2020/votervital/what-is-a-financial-transaction-tax-2/ (defining FTT's and their current status in the United States, analyzing HFT activity over the past several years, and highlighting European approaches to the same).

149. *See Complete Auto*, 430 U.S. 274.

150. *See Wayfair*, 138 S. Ct. 2080.

151. *See* Sales Tax Institute, *What is Nexus?*, SALES TAX INST (2023), https://www.salestaxinstitute.com/sales_tax_faqs/what_is_nexus (discussing the background of the term nexus and highlighting four types: click-through, affiliate, marketplace, and economic.)

152. Press Release, New York Assemblyman Phillip Steck & New York State Senator James Sanders, *RE: Response to SIFMA letter dated February 4, 2021 concerning*

in the press release, the two state legislators go on to say, "it is a tax on those who buy stock in NY. Like any other sales tax, it is paid by the purchaser; the business simply collects it and remits it to the government."[153]

While the incidence of the tax is unclear in the press release, the legislators provided a key piece of information–the proposed state legislation is a *sales tax*.[154] Because of this information, although not in the legislation itself, any questions regarding jurisdiction for tax liability fall under the purview of *Wayfair* and economic nexus.[155] Therefore, under this proposed law, if a company or individual engages in the sale or transfer of stock or similar outside of New York to attempt to avoid the tax, they will likely be unsuccessful at avoiding the tax liability.

Following the *Wayfair* decision, and in line with other states, New York enacted two safe-harbors: (1) A threshold for economic nexus (related to sales taxes) of $500,000 in sales *and* 100 transactions, and (2) a threshold for marketplace facilitators of $500,000 in sales *and* 100 transactions.[156] Therefore, if an individual or company fall within these safe-harbors, they are exempt from remitting sales tax to the state. These safe-harbors, though, apply only to the sale of tangible personal property,[157] not intangible personal property like stocks,[158] opening the door to potential issues with A7791B, and other similar proposals, moving forward.[159]

A3353/S1406 (Feb. 10, 2021), https://www.nysenate.gov/sites/default/files/press-release/attachment/stock_transfer_tax_bill_pr_003.pdf.

153. *Id.* at 4.

154. *Id.*

155. *See Wayfair*, 138 S. Ct. 2080.

156. *See* Bloomberg Law, *Post-Wayfair Nexus Roadmap*, BLOOMBERG LAW: TAX & ACCOUNTING (Archived Sept. 14, 2021); *see also* New York Technical Advice Memorandum TSB-M-19(4)S (Nov. 5, 2019) (increasing the economic nexus threshold to $500,000 from $300,000).

157. *See* TSB-M-19(4)(S) (Nov. 5, 2019).

158. *See* Cornell Law School Legal Information Institute, *Intangible Property*, WEX (2023), https://www.law.cornell.edu/wex/intangible_property (defining intangible property as "property without a physical existence[,]" which includes stocks).

159. *See* McKinney's Const. Art. XVI, § 3, N.Y. CONST. art. XVI, § 3 (2022). The New York State Constitution currently includes a provision that states in pertinent part: "Moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located at the domicile of the owner for purposes of taxation[.]" While this provision has been interpreted in terms of trusts and estates and income tax, it is possible for this amendment to be brought into question for the purposes of sales tax nexus; *see also* Burton v. New York State Dept. of Taxation and Finance, 25 N.Y.3d 732 (2015) (holding that Art. XVI § 3 does not preclude

B. The U.S. Government's Response to Occupy Wall Street

Several members of the House of Representatives in the 117th United States Congress jointly proposed legislation titled, "Wall Street Act of 2021," ("WSA") which aims to amend Chapter 36 of the United States Revenue Code under § 4475 to read, in pertinent part:

> "(a) Imposition of Tax.—There is hereby imposed a tax on each covered transaction with respect to any security.
>
> (b) Rate of Tax.—The tax imposed under subsection (a) with respect to any covered transaction shall be 0.1 percent of the specified base amount with respect to such covered transaction."[160]

While a sign of interest in re-establishing the former U.S. FTT, as of January 15, 2021, the WSA was referred to the House Committee on Ways and Means, where it did not survive review.[161] This is no surprise, as there is significant political pressure to oppose these taxes on both the federal and state level.[162] Aside from political pressure, critics of the federal approach also appropriately cite to varied results from similar taxes on a national level in Europe.[163] Should the U.S. government pass comprehensive tax reform in the form of a VAT (value-added-tax),[164] it is possible for this type of tax to be implemented through those means. Given that this bill did not pass committee, a state-based approach is the

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New York from assessing personal income tax liability and claiming jurisdiction over a non-New-York-resident's gains from the sale of shares of a foreign corporation).

160. Wall Street Tax Act of 2021, H.R. 328, 117th Cong. (2021), https://www.congress.gov/bill/117th-congress/house-bill/328/text.

161. *See* Actions - H.R.328 - 117th Congress (2021-2022): Wall Street Tax Act of 2021, H.R. 328, 117th Cong. (2021), https://www.congress.gov/bill/117th-congress/house-bill/328/all-actions.

162. *See* Declan Harty, *House Republicans Introduce Bill to Block State Financial Transactions Taxes*, S&P GLOBAL MARKET INTELLIGENCE (Mar. 3, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/house-republicans-introduce-bill-to-block-state-financial-transaction-taxes-62991558; *see also* Colin Wilhelm, *House Republicans Take Aim at Financial Transaction Tax*, BLOOMBERG LAW: TAX (Mar. 17, 2021), https://news.bloombergtax.com/daily-tax-report/house-republicans-take-aim-at-financial-transaction-tax.

163. For more information regarding the European approach to FTT, see Section I(B).

164. For a discussion as to how and why the U.S. government would benefit from the imposition of a VAT tax, see Reuven S. Avi-Yonah, *Summary and Recommendations (Symposium on Designing a Federal VAT, Part I)*, 63 TAX L. REV. 285 (2010).

most appropriate and likely avenue to impose an FTT or STT in the United States.

C. Concerns From The Financial Industry

In response to New York's stock transfer tax plan,[165] several major financial institutions and exchanges submitted a joint letter opposing the repeal of the tax credit, arguing, *inter alia*, overall loss of market profitability, investment flight risk, and increased costs of saving.[166] Additionally, the New York Stock Exchange (NYSE) President presented a statement that the exchange may relocate should the legislation pass.[167] Although this statement by the NYSE and other financial industry leaders may seem possible, the NYSE in-fact doubled down on their footprint in New York and aimed to benefit from the revenue as a major fixture in New York.[168] Given the history of the NYSE in New York and its position in the financial capital of the world, it is unlikely that an FTT or STT would lead to their departure from their historic home.

On the other hand, some support is present in the United States for STT. As noted at the outset, the initial intention behind FTT and STT are to curb speculation in the market. A high-profile company that exemplified such activity is GameStop, where speculative activity spawned renewed interest for the politicians and the public alike. Labeled as a "moribund mall retailer," GameStop shocked the world when its stock price shifted dramatically from $2.57 to $483.00 in just a few short months. Given the lack of fundamental financial support for this dramatic shift, attention shifted to the Reddit and the forum WallStreetBets, where individuals discussed stock trading strategy and often did so in a lighthearted manner. Although GameStop was regarded as a bygone corporation soon to be lost with the mall era, a phenomenon known as the "GameStop Short Squeeze" resulted in over three billion dollars in losses, the largest

165. *See* Assemb. B. A7791B § 9.

166. Kenneth E. Bentsen, *SIFMA Opposes New York Stock Transfer Tax Due to Harm to Savers and Investors*, SEC. INDUS. AND FIN. MKTS. ASSN. NEWS (Feb. 3, 2021).

167. *See* Jim Silver, *Proposed Tax Could Make NYSE Leave NY: NYSE President in WSJ*, BLOOMBERG LAW: TAX (Feb. 9, 2021), https://news.bloombergtax.com/daily-tax-report-state/proposed-tax-could-make-nyse-leave-ny-nyse-president-in-wsj; *see also* Lananh Nguyen, *NYSE Says It's Ready to Move If States Impose Transaction Taxes*, BLOOMBERG LAW: TAX (Mar. 10, 2021), https://news.bloombergtax.com/daily-tax-report-state/nyse-says-its-ready-to-move-if-states-impose-transaction-taxes.

168. *See* Section I(A)(3).

trading squeeze in 25 years. Regardless of the intention of the Reddit community, this speculative activity caught the attention of lawmakers and the public alike.

On one hand, some lawmakers use the GameStop phenomenon as an example of highly speculative activity that should be prevented through a tax, harkening back to the basis of a financial transactions tax.[169] On the other hand, lawmakers use this as an opportunity to highlight the risks of alienating small-time investors and putting an undue limitation on retail investors.[170]

D. A New Approach: New York's 2023 Proposal

In a development similar to Occupy Wall Street,[171] several New York Legislators have proposed a string of legislation called the "Invest in Our New York Campaign" ("IONY"), where the ultimate goal is to pass the "Invest in Our New York Act" ("IONYA").[172] The IONYA aims to reduce tax benefits to high-earning individuals to shore up the state deficit, including a restructuring of the state income tax, raising taxes on the top five percent of state earners, creating a new capital gains tax, the creation of an heirs tax, and a mark-to-market Billionaires Tax.[173]

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169. *See* Joe Light, *Wall Street Transaction Tax Wins Backers on GameStop Furor (1)*, BLOOMBERG LAW (Feb. 19, 2021), https://www.bloomberglaw.com/bloomberglawnews/daily-tax-report/X1SR7020000000?bna_news_filter=daily-tax-report#jcite (highlighting the nominal nature of most proposed STT and how it would create a disincentive for speculative activity).

170. *See* Jad Chamseddine, *Republicans Use GameStop Hearing to Attack Transactions Tax*, TAXNOTES (Feb. 22, 2021), https://www.taxnotes.com/tax-notes-federal/legislation-and-lawmaking/republicans-use-gamestop-hearing-attack-transaction-tax/2021/02/22/2zf2w?highlight=gamestop (discussing the concern that some legislators have regarding incidence of tax and likelihood of reaching the goal of reducing speculation in the market).

171. For a brief discussion of the Occupy Wall Street Movement, see Wade, *supra* note 131.

172. Although this movement began in 2021, this renewed 2023 effort on the part of New York legislators aims to effectuate the intended change by targeting tax incentives provided to large corporations and high-net worth individuals. For additional details on the results of the 2021 plan, see Invest in our N.Y. (IONY), *2021 Short Summary, Invest in Our New York*, (2021), https://www.investinourny.org/media/pages/2021-wins/0c7c915ae1-1620422389/2021_shortcampaignsummary.pdf.

173. *See* Carolyn Martinez-Class (Invest in Our NY Campaign Manager), *Invest in Our NY is calling on Gov. Hochul to raise $40 Billion in Public Money to Invest in Working-Class Communities*, IONY (Jan. 23, 2023), https://investinourny.org/media/pages/home/ce23294f11-1675221384/iony-plan-to-raise-40-billion-in-public-dollars-1-23-22-1.pdf; *see also* Stephanie Wright, *"We Need Real Change, Now:" Invest in Our New York Campaign Kicks*

On January 19, 2023, one of the major proponents for this movement, Senator Robert Jackson was seen rallying for this movement in front of the New York "Towers of Power,"[174] where he stated: "I'm asking you now, help the people of New York City by sharing some of the wealth that you have . . . if not, we're going to pass legislation to make you pay for it."[175]

On January 20, 2023, four New York State Senators proposed Senate Bill S2402, a bill that amends, rather than repeals, Section 280-A.[176] According to the IONY campaign, this legislation "[creates] a tax on Wall Street Transactions," because "the state doesn't have any tax for trading stocks and bonds."[177] To quote Albert Einstein, at times, "the framing of a problem is often far more essential than its solution."[178] While one could construe a 100 percent rebate on the only remaining substantial tax on the books in the United States as the state not having a tax, the legislation provides otherwise. S2402 amends the existing rebate law by reducing the rebate from 100% to 60%, with the remainder of funds going to the general state infrastructure investment fund.[179] S2402 was referred to the Senate Finance Committee on January 20, 2023, and as was the case with the federal bill, it did not make it out.[180]

Off, THE DAILY ORANGE (Dec. 7, 2022, 1:32 AM), https://dailyorange.com/2022/12/invest-new-york-campaign-kicks-off/.

174. The New York Towers of Power are a cluster of apartment buildings in Manhattan, NY, where several ultra-high net worth individuals are known to have residences. For additional information on the towers, see Adam Bonislawski, *Hitting New Heights: Midtown's Most Coveted Towers of Power*, NEW YORK POST (Feb. 25, 2015), https://nypost.com/2015/02/25/hitting-new-heights-midtowns-most-coveted-towers-of-power/.

175. Lauren Aratani (@LaurenAratani), TWITTER (Jan. 19, 2023, at 1:57 PM), https://twitter.com/LaurenAratani/status/1616147868389097475?s=20; *see also* Lauren Aratani, *Tax the Rich, Urge Protesters at New York City's 'Towers of Power'*, THE GUARDIAN (Jan. 19, 2023), https://www.theguardian.com/us-news/2023/jan/19/new-york-taxes-super-wealthy-protest-towers-of-power.

176. Although not a part of the IONY campaign formal proposal, it is likely that this bill is part of the overall plan, as NY Senator Jackson is a co-sponsor. S.B. S2402 (N.Y. 2023); *compare* Assemb. B. A7791B (N.Y. 2021).

177. Sachi McClendon, *Electeds: Raise Taxes on Ultra-Rich*, THE RIVERDALE PRESS (Dec. 16, 2022), https://www.riverdalepress.com/stories/electeds-raise-taxes-on-ultra-rich,89512.

178. *Albert Einstein Quotes*, GOODREADS (2023), https://www.goodreads.com/quotes/966500-the-framing-of-a-problem-is-often-far-more-essential.

179. *See* S.B. S2402, at 1–2, lns. 18–22, 38–40. (N.Y. 2023); *see also* Michael Nunes, *NY State Bill Seeks to Reduce Stock Transfer Tax Rebate*, LAW360 TAX AUTHORITY (Jan. 23, 2023), https://www.law360.com/tax-authority/articles/1568306/ny-senate-bill-seeks-to-reduce-stock-transfer-tax-rebate.

180. The New York State Senate, *Senate Bill S2402 – Current Bill Status* (2023), https://www.nysenate.gov/legislation/bills/2023/S2402.

Similar to Assembly Bill A7791B (2021), S2402 does not address several key issues: who bears the incidence of tax, whether ability to pay is considered, and how the bill will impact the overall market. While this avoids some of the recharacterization issues in light of *Wayfair* and its progeny, it is subject to the same market-effect issues its predecessor likely succumbed to. A forty-percent reduction in the rebate, as opposed to an elimination, will likely have the same market chilling effects. Institutional investors and HFT firms will likely pass this cost along to investors through the form of transaction fees and will further increase the costs of investment for regular, retail investors. It is no surprise that this latest iteration did not survive the NY Senate Budget Committee, given its impact on retail investors, and the overall chilling effects on the market.

VI. PROPOSED SOLUTION(S)

Given the concerns presented by both the general public and financial industry firms, New York must make several changes to their approach in order to successfully implement a stock transfer tax. Additionally, New York is in a unique position to both generate tax revenue and protect the sanctity of the global financial market by providing a barrier to curb an inevitable financial crisis led by out-of-control high-speed HFTs, as was seen in 2010. Unlike the approaches taken by European counterparts, a federal approach in the United States will not be as effective, as partisanship and constitutional issues will present roadblocks that are not easily resolved.[181]

A. Clear Statutory Language

The current statutory language in New York is unclear and requires revision to effectively enact the proposed legislation. Two main areas of concern exist: (1) The current statures do not expressly state which party or parties bear the incidence of the tax, and (2) an unresolved conflict exists between the current and proposed statutory language and the Federal Securities Acts of 1975.[182] In order to resolve these concerns, this Article proposes

181. James S. Henry, David Hillman & Nicholas Shaxson, *The Time for Financial Transaction Taxes is Now*, TAX NOTES FEDERAL: CURRENT AND QUOTABLE (Mar. 23, 2021).
182. *See* Hellerstein, *supra* note 54.

that New York legislators consider revising the proposed language in Bill A7791B or Bill S2402 (and any subsequent legislation) to include specific language that indicates the nature of the stock transfer tax as a sales tax. Without this language, there may be question as to whether the nexus requirement as presented in the legislation relates to physical presence nexus, increasing the potential for taxpayer migration; or economic nexus, which will allow the state to impose a tax on any taxpayer that is outside of the stated *Wayfair* safe-harbors.[183]

Should the legislature choose to adjust the language in this manner, the state should then conduct a study to determine if an upward adjustment is required to the existing *Wayfair* $500,000 and 100 transactions safe-harbor. Given that a strict interpretation of the safe-harbor does not provide a safe-harbor for intangible personal property,[184] the lack of a clear safe-harbor may prove to be a barrier to entry for start-up investment firms that may grow, leading to a potential loss of talent to other states.

The second issue, conformity with the Federal Securities Regulation Acts of 1975,[185] will present a larger issue for New York. The 1975 Act provides that a state may not tax a change in ownership of a stock when fulfilled through a clearinghouse, unless such a state is entitled to do so. As it currently stands, the only way a state is entitled to do so is if the clearinghouse is within that state (here, for example, New York).[186] When considering the proposed STT as a sales tax, the state will likely face instances where economic nexus is met solely through a clearinghouse, and New York will likely seek to tax that transaction. As written, both the current and proposed legislation do not address this issue, and a separate provision should be added exempting these transactions; otherwise, these taxes will be pre-empted by federal law. However, there is a potential for loss of revenue, as a significant number of transactions are completed through clearinghouses.

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183. *Id.*
184. *See* N.Y. CONST. art. XVI, § 3 (2022).
185. *See* Swain, *supra* note 42.
186. *See* Miller, *supra* note 74.

B. Targeted Credits

Through the existing elective-rebate system, New York can effectively raise funds and present a nominal barrier to entry to prevent dangerous HFT activity through an amendment to NY Tax Law 280-A.[187] In order to protect long-term investors and those not engaging in speculative activity, New York need not remove the elective credit, as that provides a means in which clearinghouses and individuals incur no additional trading cost. However, this Article proposes that amending the elective credit and imposing a nominal tax, as currently outlined, on HFT and other highly speculative trading will provide a nominal barrier to entry and raise significant revenue. This approach provides New York with access to over seventy-five percent of market activity with two enforcement benefits.

First, HFT firms, absent dramatic technological advances, are at a competitive disadvantage should they choose to leave the state due to latency requirements.[188] This circumvents the out-of-state economic nexus requirements, as these firms are still within the state's borders. Additionally, should the legislature classify this tax as a sales tax, economic nexus will likely permit them to collect this tax regardless of where the firm is located, as HFT engage in business with millions of companies, many of which likely have subsidiaries in New York.

Second, this approach will have an added benefit of reducing unhealthy market speculation. Unlike the British approach that encourages speculation,[189] or the French approach that characterizes financial transactions taxes as reparations for the 2008 Great Recession,[190] this proposed approach will allow New York to permit healthy market activity while imposing a nominal cost to those who choose to speculate.

However, while not a new tax, selectively imposing a tax on particular individuals or corporations while providing a credit to others may have some implications under the Equal Protection Clause.[191] If challenged, these classifications are analyzed as to

187. *See supra* note 120–21.

188. See Section II(B) for a discussion regarding latency and technological advancements in High-Frequency Trading.

189. See section IB(2) for a discussion regarding the United Kingdom's approach to Financial Taxes.

190. See section IB(1) for a discussion regarding the French approach to Financial Taxes.

191. *See* U.S. CONST. amend. XIV.

whether "the State's Classification is 'rationally related to the State's objective.'"[192] New York will likely succeed in defending against any Equal Protection Clause claims, as New York has a state objective of "[guarding] against financial crises, and to protect consumers and markets from fraud."[193]

By classifying this renewed Stock Transfer tax as a sales tax and revising existing statutes to provide traditional traders with a credit but electing not to extend that credit to HFT trades, New York can effectively collect on seventy-five percent of trading, while still allowing for unburdened traditional investment and healthy market activity.

V. CONCLUSION

FTT, specifically STT, have a long history both in the United States and abroad. With the exception of a nominal federal tax, there are no FTT or STT collected in the United States. The varied approaches presented by European nations provide insight into effective and ineffective practices. The rise of HFT presents a host of regulatory concerns that need to be addressed immediately. In the United States, a state-level regime is the most efficient way to do so since national concerns have caused this type of legislation to fail in the past. New York's existing tax regime, the only existing system in the United States, should be adjusted to reflect modern trends in the marketplace. This approach can be effectuated through strategic credits that would support traditional market functions and create minimal barriers to entry for HFT, while raising much-needed funds and protecting traditional market activity.

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192. *See generally* Andrew D. Appleby, *Subnational Digital Services Taxation*, 23 (88 MARYLAND L. REV. 1 (2021), STETSON U. COL. OF L. RES. PAPER NO. 2021-3), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3811001 (although discussing tax characterization in context of digital taxes, provides general insight into judicial review of Equal Protection Clause cases in a taxation context (citing Harrah Indep. Sch. Dist. v. Martin, 440 US 194 (1979) (quoting Mass. Bd. of Retirement v. Murgia, 427 US 307, 315 (1976))).

193. New York State Department of Financial Services, *Our Mission* (2023), https://dfs.ny.gov/node/11321.

MIDDLE GROUND: A DISCUSSION ON CIVILITY BETWEEN OPPOSING COUNSEL

Matthew Crouch[1] and Niral Gandhi[2]

The dictionary definition of middle ground is "a position between two opposite opinions in an argument, or between two descriptions."[3] It also happens to be the name of the second location operated by Thomas Lord as a playing field—now referred to as "Lord's Middle Ground"[4] since the building of the present location for Lord's Cricket Ground in 1814.

Matthew Crouch began working as an attorney for the Harris Central Appraisal District[5] in 2014, defending the District in state courts regarding challenges to property tax values. Niral Gandhi is a founding partner of the Dallas-based firm of Estes & Gandhi, P.C.[6] and represents plaintiffs in challenging property tax values throughout Texas. Matthew and Niral would find themselves as opposing counsel on anywhere from ten to twenty cases annually, with more cases being heard in settlement conferences. Matthew would act as the "attorney in the room" on dozens of other cases where Niral and his law partner would be acting for the plaintiffs. Matthew and Niral met for the first time during a multi-day settlement conference in 2015 and, through their best practices in civility, found common ground between them that helped establish

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1. Attorney licensed in Colorado, Texas and as a solicitor in England and Wales (non-practicing), before the United States Supreme Court and numerous federal courts. B.S., 1998, Colorado State University; J.D., 2000, St. Thomas University School of Law; LL.M., 2002, University of Denver Sturm College of Law.

2. Attorney licensed in both federal and state courts in Texas. B.B.A., Economics (summa cum laude), 2005, Baylor University; J.D. (with honors), 2008, University of Texas; CMI-property tax, Institute of Professionals in Taxation, 2013.

3. *Middle Ground*, CAMBRIDGE ENG. DICTIONARY, https://dictionary.cambridge.org/us/dictionary/english/middle-ground (last visited Dec. 18, 2023).

4. *Lord's*, WIKIPEDIA, https://en.wikipedia.org/wiki/Lord%27s (last visited Dec. 18, 2023); *see also MCC Beat Hertfordshire in First Match at Lord's*, LORD'S, https://www.lords.org/lords/our-history/father-time-wall/1814-mcc-beat-hertfordshire-in-the-first-match-at (last visited Dec. 18, 2023).

5. Homepage, HARRIS CENTRAL APPRAISAL DISTRICT, https://www.hcad.org (last visited Dec. 18, 2023).

6. *Share Holders and Attorneys*, ESTES & GANDHI, P.C., https://www.estesgandhi.com/new-page-78 (last visited Dec. 18, 2023).

a solid working relationship, which lasted throughout Matthew's eight years at the District and beyond.

The common ground started with discussing cricket. Before long, Niral and Matthew were chatting about the Indian Premier League ("IPL")[7], players, and various matches occurring during the IPL season, many of which were being played during the settlement conference days.

In the preamble to the Laws of Cricket ("Laws"), there is a discussion about the "Spirit of Cricket"[8]—officially incorporated into the Laws at L41.1—which requires team captains to ensure their teams play within the "Spirit of Cricket."[9] This includes the following guidelines on conduct:

> Respect your captain, team-mates, opponents, and the authority of the umpires.
>
> Play hard and play fair.
>
> Accept the umpire's decision.
>
> Create a positive atmosphere by your own conduct, and encourage others to do likewise.
>
> Show self-discipline, even when things go against you.
>
> Congratulate the opposition on their successes, and enjoy those of your own team.
>
> Thank the officials and your opposition at the end of the match, whatever the result.[10]

Similarly, attorneys must abide by the Rules of Professional Conduct in their own jurisdictions.[11] Some attorneys also adopt additional codes, which may not be mandated in their jurisdictions, but serve as aspirational guidance for attorney conduct. The Texas Attorney's Creed is one example, as is the Professional Creed of the

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7. Homepage, INDIAN PREMIER LEAGUE, https://www.iplt20.com/ (last visited Dec. 20, 2023).

8. *Preamble to the Laws: Spirit of Cricket*, LORD'S, https://www.lords.org/mcc/the-laws-of-cricket/preamble-to-the-laws-spirit-of-cricket (last visited Dec. 18, 2023).

9. *Unfair Play*, LORD'S, https://www.lords.org/mcc/the-laws-of-cricket/unfair-play (last visited Dec. 18, 2023).

10. *Preamble to the Laws: Spirit of Cricket*, *supra* note 8.

11. *See* MODEL RULES OF PRO. CONDUCT r. 8.5 (AM. BAR ASS'N 1983).

American Inns of Court.[12] The American Bar Association further provides a webpage dedicated to all of the Professional Codes by state as a resource for attorneys.[13]

Following Matthew's departure from the District, he and Niral got together to discuss the practicalities and realities of their respective positions as adversaries and whether there be grounds to act with civility while constantly battling on opposing sides. This article is a compilation of those discussions from two very different sides of a case, yet both working towards a common "middle ground."

HOW CAN CIVILITY AND ADVERSARIAL POSITIONS CO-EXIST?

Niral Gandhi (NG): Civility *is not the same as being agreeable*. In fact, it is because there is an anticipation of conflicting opinions that makes civility more important in a profession designed to be adversarial. The legal profession is an easy one for attorneys to become vested in their position. An attorney's job is to advocate for their client within the rules and the laws set forth by statutes, the rules of governance, and the rules of the court. In most situations, opposing counsel may have a different, but also reasonable, understanding of the law, rules, facts, court findings, and other things, which can make the two attorneys have adversarial positions in a case. However, none of these adversarial positions require the attorneys to act uncivilly towards one another.

Matthew Crouch (MC): The co-existence of civility and adversarial positions could be the default starting place for things, and should be as attorneys—a place where adopting a scorched earth policy from the get-go simply cannot be reasonable. Start with the basic role of lawyers—as attorneys, one of our primary roles is to act on behalf of a client and that necessarily means being capable of holding a line somewhere. The Model Rules of

12. *The Texas Lawyer's Creed—A Mandate for Professionalism*, (SUP. CT. OF TEX. & COURT OF CRIM. APPEALS 1989); *The American Inns of Court* https://www.txcourts.gov/media/276685/texaslawyerscreed.pdf; *Professional Creed*, AM. INNS OF CT., https://www.innsofcourt.org/AIC/About_Us/Professional_Creed/AIC/AIC_About_Us/American_Inns_of_Court_Professional_Creed.aspx (last visited Dec. 19, 2023) .

13. *Professionalism Codes*, AM. BAR ASS'N, https://www.americanbar.org/groups/professional_responsibility/resources/professionalism/professionalism_codes/ (last updated Mar. 2017).

Professional Conduct ("MRPC") preamble sets out three roles of lawyers, and the first role is as a representative of a client.[14] Several additional roles come with being a representative of a client and a main role is that of an advocate.[15] An advocate "zealously asserts the client's position under the rules of the adversary system."[16] Advocacy does not stop with this though—it is tied to the role of lawyers as negotiators. "As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealings with others."[17] The notion of honesty is foundational, yet one not guaranteed in practice.

A great description of the opposing strain of these positions comes from a Canadian attorney who wrote:

> The tension between being civil and being a forceful and fierce advocate is one more stress added to the many other aspects of our legal profession that cause stress - - pressure of billable hours; pressure to collect fees; long hours; the detailed and exacting nature of our work accompanied by severe consequences if performed otherwise; increasingly, the expectation of a quick turn around; conflicted and sometimes emotionally disturbed clients; files which often involve the most troubling of human emotions; and an adversarial environment where a fellow lawyer is paid to attack you and your client, to try to prove you wrong and sometimes stupid, all in front of your client who is expected to pay you for your brilliance, abilities and advocacy.[18]

It is an easy step to take from being zealous to dropping any pretense of civility and unfortunately, it is easy when you start representing clients in a defense or plaintiff situation on a regular basis. An us versus them mindset can almost become a point of doctrinal instruction in certain jobs and, in those cases, zealous can overtake civil easily.

Co-existence of these principles requires self-awareness and emotional intelligence. Knowledge of how you act and react as an attorney, what buttons can get pushed, what do you do when that

14. MODEL RULES OF PRO. CONDUCT, pmbl. para. 1 (AM. BAR ASS'N 1983).
15. *Id.* pmbl. para 2.
16. *Id.*
17. *Id.*
18. Ron Profit, *Civility in the Legal Practice: Practical Tips*, CANADIAN BAR ASS'N (July 16, 2014), https://www.cba.org/Publications-Resources/CBA-Practice-Link/Young-Lawyers/2014/Civility-in-the-Legal-Practice-Practical-Tips?lang=en-ca.

happens—knowing these things makes civility easier to achieve, because you know the traps that go in opposite directions.

HOW DO YOU USE YOUR KNOWLEDGE OF AN OPPOSING COUNSEL WHEN YOUR CLIENT HAS AN AGGRESSIVE OR WHAT SEEMS TO BE IMMUTABLE POSITION THAT CAUSES YOUR CLIENT'S CASE AND CIVILITY TO CLASH? DO THE RULES OF PROFESSIONAL CONDUCT REPLACE CIVILITY IN THOSE CIRCUMSTANCES, OR CAN THEY BE HARMONIZED?

NG: As much as possible, it is critical to harmonize representation for your client and civility. The American Bar Association's MRPC begins its preamble with a statement that "[a] lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice."[19] The Texas Rules further add that "[l]awyers, as guardians of the law, play a vital role in the preservation of society."[20] Although there may be situations where balancing the interests of the client and the greater good may be difficult, it is the attorney's charge to act as the competent intermediary between the client, the court, and/or opposing counsel. In fact, it has also been mandated by the Texas Supreme Court and the Court of Criminal Appeals when they jointly promulgated the Texas Lawyer's Creed, which mandated professionalism amongst the attorneys in the state in 1989.[21] In my experience, however, civility and client relationships have rarely been an issue as long as the client is informed on the process and the plan.[22] If a client is aware of the procedures and the progress of the case, there tends to be harmony with civility and the client's case. Having knowledge of opposing counsel also aids in determining the strength of your case. Part of being an advocate is to provide your clients with the risks and likelihood of success so that they can make informed decisions on how and when to proceed

19. MODEL RULES OF PRO. CONDUCT, pmbl. para. 1 (AM. BAR ASS'N 1983).
20. TEX. DISCIPL. RULES OF PRO. CONDUCT, pmbl. para. 1 (STATE BAR OF TEX. 2022).
21. THE TEXAS LAWYER'S CREED—A MANDATE FOR PROFESSIONALISM, (SUP. CT. OF TEX. & COURT OF CRIM APPEALS 1989).
22. *See* MODEL RULES OF PRO. CONDUCT r. 1.4 (AM. BAR ASS'N 1983) (setting forth the communication requirements for attorneys with clients).

with their case.[23] Knowledge of opposing counsel, the judge, court, jury pool, experts, and other parties all impact this risk/reward calculation.

MC: At some point, civility and the MRPC have to be harmonized. If they cannot be, then what I have failed to do is larger than me or my client. Looking at the practicalities of this though, as an attorney, one of my jobs is to advise my client of the practical, real-world, rubber-meets-the-road implications of their rights and obligations.[24] That advice includes more than just the applicable law, but other considerations. While the MRPC discuss "moral, economic, social and political factors,"[25] to me these include practical considerations as well, like drawing on experiences, either mine or my colleagues, with local courts and judges so that I could advise whether there are litigation risks that affect the claims. My task as an advocate is to be able to advise on both the strengths and weaknesses of my client's position.

The benefit of knowing who the opposing counsel is in any specific type of litigation comes from getting to know them as a person and as an advocate. The more time I spend with them, the more I can understand whether the position they are taking is one that has merit and how the courts will look on that position. If I have worked with an opposing attorney on a regular basis, I can advise my client of any additional risks as a result. Sharp, smart attorneys who can see the strengths and weaknesses on both sides can make for a challenging adversary, and that can be useful to know in advising my client appropriately.

That being said, there have been times when my client, or my client's representative, and I had loud discussions, arguing back and forth on the merits of the positions of all parties. Just as often, opposing counsel with whom I've had frequent interaction had their own patterns and methods. Experience taught me that I could draw on past interactions with opposing counsel to anticipate issues and find common ground in resolving the issues. Once the scope of the issues could be narrowed, there was a little breathing room which could often be used to bring things back to a more civil place in attempting to negotiate resolutions.

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23. *See id.* at r. 1.4(b) (stating that "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.").

24. *See* MODEL RULES OF PRO. CONDUCT, pmbl. para. 2(AM. BAR ASS'N 1983).

25. MODEL RULES OF PRO. CONDUCT r. 2.1 (AM. BAR ASS'N 1983).

HOW DO YOU DEFINE CIVILITY AS A PLAINTIFF/DEFENSE ATTORNEY?

NG: Surprisingly, I have found that not all individuals define civility the same. For me, my concept of civility is derived from various religious and historical texts that all follow the same concept: do unto others as you would like them to do to you. This is found in most (if not all) religious teachings (see “the Golden Rule” under Matthew 7:12, The Mahabharta Anusasana Parva 113, etc.) as well as most ethics guides. Although this can be difficult to relate to law, I strongly believe that most lawsuits are because the plaintiff truly feels that they have been harmed and most defendants truly believe the plaintiff has not been harmed. With that understanding, many cases can be resolved purely by communicating opposing theories to the parties.

MC: My primary job has been as a defense counsel for about 10 years now, representing governmental entities. So, how I define civility relates to my own role—my client has a function that helps society in ways that many people do not understand, and misunderstanding the functions of these entities is more common than not. So, I try and view my role as having both internal and external facets. Internally, I have clients who expect certain results. Sometimes, when you are representing an entity like an agency or corporation as a client, there are separate internal units who may have similar goals but have different requirements as to how those are accomplished. I have been lucky because I represent clients who are very conscientious about ensuring their duties are fulfilled in a manner that the general public can trust and rely on being applied fairly and equally, even in litigation. At the same time, there are times when an error gets made somewhere along the way. That is the nature of life and happens to any entity. So, sometimes it is a matter of explaining how the error can be fixed and, in other cases, it is a matter of handling that through resolution of litigation.

From an external-facing stance, a big part of my role as the attorney that is acting in a manner where unrepresented parties I encounter are met with civility and professionalism, whether in a litigation stance or not, such that they come away from the experience with a better view of my client, if possible. Sometimes, that is a matter of helping these parties and acting as an educator. Occasionally, it is acting as a counselor, helping them understand if there was an error on their part, and explaining how those facts interplay with the law. Even if the result is not in their favor, I try to aid in helping them understand more about the entire process than they did before and do so with a sympathetic ear.

WHAT ARE YOUR PERSONAL BEST PRACTICES TO ACT WITH CIVILITY IN A PROFESSION WHICH IS DESIGNED TO BE ADVERSARIAL?

NG: Civility and confrontation are not mutually exclusive. I have related that to youth sports as a way to remember this. The other day I went to my daughter's soccer match, which ended up being 40 minutes of nonstop action with both teams playing their hearts out. At the end of the game, both teams lined up to give "high-fives" to the other team. There was no animosity to be seen even though both teams had opposing goals (no pun intended) throughout the entire game. Bringing back to the introductory cricket theme, this can also be seen at the highest level after international and IPL matches where opposing players chat and high five once the games are completed. This is a reminder of what most adversarial professions are supposed to be. Confrontation with opposing counsel is what the legal profession is about, but it must be done with respect for them and the process.[26] As a firm, we often discuss heated cases internally so that we can remind each other not to become too vested in any given argument. Outside of that, however, I am not sure if there is a "personal best practice" for me regarding this except for periodically reminding myself of this and by separating my home and office.

MC: I have to divide these into two pots: one for the day job, and one for my own personal self. For the day job, I sometimes have to step back and take a breath. It is easy to spiral into the easily entrenched positions as adversaries, attacking arguments and facts, but it is a slippery slope on occasion. Sometimes stepping back and breathing for a few moments allows a chance for rational thought to take the place of verbal sparring and to see if there is a way to get things back on track. Within the law, I also have pursued law-related activities and volunteer projects, like volunteering for local LegalLines.[27] By participating in these

26. MODEL RULES OF PRO. CONDUCT, pmbl. para. 5 (AM. BAR ASS'N 1983).

27. Local bar associations will sometimes hold sessions or provide a service where members of the public can call in and ask legal questions which are answered by attorneys

activities, whether bar-sponsored or not, I get to know a broader base of people involved in the legal profession and that has helped me in numerous ways, not the least by hearing about other people's experiences in the profession and learning from that.

As for the second pot, when I leave the day job, I try to separate what I do as an attorney with who I am outside of that. I have several hobbies, none of which engage the same areas of my brain as the ones I use when I am serving as an attorney. Plus, these hobbies have the added benefit of exposing me to people outside of the usual suspects of attorneys I end up litigating with on a regular basis. Those interactions help remind me that there is life outside of the law and that I do not have to maintain the adversarial mindset that I have to use when litigating. I have let this help guide some of my practices in the day job, and it has proven to be helpful in reducing some of the inherent tensions that come from litigating.

WHAT DO YOU DO TO LAY A FOUNDATION WITH AN OPPOSING COUNSEL TO MAKE THE FIRST CASE(S) YOU HAVE EASIER? DO YOU DO THE SAME WITH ALL OPPOSING COUNSELS OR IS THAT INDIVIDUALIZED?

NG: I found that most of my initial communications with opposing counsel are not related to the issues of the case. It can be difficult to find common ground related to the issues at hand, but that difficulty typically does not extend to matters outside of the case. Speaking about the issues immediately creates tension in the room well before the actual arguments begin. Instead, by discussing something non-confrontational, you can begin to build some common ground with opposing counsel. Building common ground provides an avenue to make future communications more comfortable, even if adversarial. I typically would treat all opposing counsel the same. We are all peers in the industry trying to achieve the best results for our clients but also trying to get the correct overall result. I historically have found that most opposing counsel all want the same thing; however, when we find opposing

volunteering their time and expertise. *See generally* LegalLine, HOUS. BAR ASS'N, https://hba.org/index.cfm?pg=LegalLine (last visited Feb. 13, 2024); LegalLine, DALL. BAR ASS'N, https://www.dallasbar.org/index.cfm?pg=legalline (last visited Feb. 13, 2024); LegalLine, TARRANT CNTY. BAR ASS'N, https://www.tarrantbar.org/?pg=LegalLine (last visited Feb. 13, 2024); LegalLine P.M., Phila. Bar Ass'n, https://philadelphiabar.org/?pg=YLDLegalLine (last visited Feb. 13, 2024).

counsel that are not acting under the same premise, it really does not change my approach to them or the case.

MC: That is a matter of putting my best practices into effect from the get-go, combining the practice of civility with the role of attorney. I personally find it helps when I am able to talk to opposing counsel or a pro se party. I can find out quickly a lot about the difficulties of a case and what kinds of early resolution opportunities exist, if any. I try to do that with every opposing counsel, often with a quick introductory call if possible. Communication is a major part of what we do and trying to establish good lines of communication early on helps, especially if there is a solid chance that the case may be tricky, or if there will be multiple cases over time. If I have not dealt with them before, communication is a blank slate, which can be useful. Even if I have been told horror stories about them, I start with the blank slate if possible. If their behavior later proves to be in line with what others have said, usually I am more disappointed in them than anything. Nonetheless, I strive to remain civil.

DOES CIVILITY EVER STOP? IF IT DOES, CAN IT BE REGAINED?

NG: Civility is a mindset that should not begin or end with the profession. I have also found that individuals tend to desire a civil community over an adversarial one. Along those lines, several years back my brother and I ran our own experiment where, as we drove in our residential subdivision, we waved at all of the other drivers, pedestrians, bicyclists, children playing on the street, and anyone else we saw. Our subdivision was quite large, and we were fairly new to the area, so we hardly knew any of our neighbors at the time. At first, a few waved back; however, as we continued to do this for a few months, we found most of the community waved back not just at us, but at the other community members as well. This minor change proved to me that civility is an act anyone can choose to do regardless of who is receiving it.

That being said, civility can stop since not all attorneys (or people for that matter) believe in civility as a requirement. In addition, maintaining civility requires discipline and can be very difficult, especially when provoked. However, if civility is lost for a brief period, it can be regained over time. It may be a difficult and arduous task since once a trust is broken, it will be difficult for others to trust again.

MC: Civility certainly can stop, and even if it is replaced, to me there is always a worry that it can be lost again. I have been guilty of this once in a while. For example, there have been times where I learn that an attorney who I see or have as an opposing counsel had their license to practice suspended for failing to keep up with Continuing Legal Education ("CLE") requirements. I have seen this happen, both when I was a law clerk and in practice, each with different results. I think in both cases, it speaks to civility. When I was a law clerk, a relatively young attorney got suspended for failing to keep up with his CLE requirements. Opposing counsel in his cases had no issue with continuing cases to allow him a chance to catch up on his CLEs and get reinstated. I think a big function of that being allowed to happen was because of how this attorney got along with opposing counsel and the court. In contrast to that, a much more senior attorney who was lead opposing counsel to my client on a number of cases had his license administratively suspended twice during the pandemic. This attorney and I butted heads on several occasions in litigation. Unlike the attorney in the prior instance, this attorney kept acting as though his license had not been suspended at all (the bar would retroactively reinstate him once he caught up). I ended up drawing a hard line and refusing to negotiate settlements with this attorney until he was reinstated. My ability to maintain civility with that opposing counsel was reduced to the bare basics. I refused to use his first name in any conversations and would only refer to him as "Mr. [Last Name]," because that is the bare minimum of courtesy I would show him if we were in court. Can civility be regained? Yes, but it requires effort on both sides.

HOW DO YOU MAINTAIN CIVILITY WITH OPPOSING COUNSELS? HAS THIS CHANGED SINCE THE PANDEMIC?

NG: The world has changed after the pandemic, and I have found that maintaining civility has become more difficult after the pandemic for various reasons. First, pre-pandemic most of my initial communications with opposing counsel were not related to the issues of the case at hand. It can be difficult to find common ground related to the issues at hand, but that difficulty typically does not extend to matters outside of the case. Building common ground provides an avenue to make future communications more comfortable, even if adversarial. Since the pandemic, however, the initial "ice-breaking" communications are more difficult. Second, email is a great tool, but it also comes without context. It is sometimes difficult to understand the context the sender intended when reading an email, which in turn may alter the way the email is interpreted. Finally, there is a lack of downtime now when communicating about an issue. Pre-pandemic, if you were to attend a mediation, court hearing, settlement conference, or other meeting, there is typically some time prior to the event beginning where you can discuss. Post-pandemic, the majority of communication occurs by phone, email, or Zoom, all of which most individuals are trying to get to the point of the initial contact as quickly as possible. The lack of downtime from the task at hand has made it more difficult to find the common grounds that were more common in the past.

MC: Maintaining civility starts with being friendly, not just polite. Getting to know opposing counsel as a person, not an adversary. At the outset, it is finding common ground, and using that as a way to build a working relationship and a basis for trust in representations made during negotiations and litigation. Like with Niral, it was discussing multiple topics and eventually finding things we both enjoyed, such as cricket. With other counsel, it has been stories about travel, cooking, hobbies, which live shows we have enjoyed and why. Building that kind of working relationship takes time, as well as multiple experiences with the opposing counsel. Each interaction can be built on little by little until you have established mutual respect and a good working relationship. This approach helped tremendously during the pandemic, as a lot of how things used to be done got pushed aside. For example, we used to have multiple days of settlement conferences with opposing counsel and client representatives from both sides, where we would get to know each other over a solid period of time. In fact, we would refer to it as "conference season" and we would often begin in the autumn and continue, with various law firms at different times, until late spring or even into the early summer. The conferences switched to virtual or phone conferences, and many of those relationships took hits almost immediately, because you lost a lot of the casual conversation which would take place when you were handling things in person. That aside, with opposing counsel that I frequently interacted with, the adjustments were definitely easier.

WHAT HAPPENS WHEN BEING AN ADVERSARY TRUMPS CIVILITY?

NG: This is a trick question in my opinion since being an adversary is not related to civility. Often there are situations where both attorneys and clients are not willing to back down from their positions because they feel strongly about it. Although settlement is a common outcome now due to the rising costs of litigation,[28] the original (and still true) purpose of the judicial trial process is to provide an outcome for two immutable positions. In such situations, being an adversary is a critical part of the litigation process; however, just as critical is the ability to maintain professionalism with the judge, jury, witnesses, opposing counsel, and all others involved. Early on in my career I was taught that no matter the fierceness of the trial or hearing and no matter the outcome, you should end the day willing and able to take opposing counsel out for drinks at the nearest bar.

MC: There have been times when an opposing counsel has attacked, either individually or as a whole, the working staff at the agency I represent. In those circumstances, I admit my buttons get pushed, as I personally believe there is no need to make such attacks and I cannot recall any times I have resorted to making those attacks myself. In the few cases I can recall where opposing counsel has made those kinds of personal attacks, I have sometimes had anger overtake civility and my voice raised to defend my client and its staff. Dialing it back down takes effort on my part, as the opposing party certainly had no interest in doing so. I can think of at least one circumstance where a plaintiff's attorney did apologize for the attack during a call. In that case, I had challenged this attack and was able to de-escalate things. That I had to do this at all still sticks in my mind and I keep it as a measure of behavior on my part.

The bigger worry comes from times when I have dealt with an opposing counsel who: 1) had horror stories told to me about how

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28. *See* Jeffrey Q. Smith & Grant R. MacQueen, *Going, Going, but Not Quite Gone*, 101 JUDICATURE 26, 28 (2017) (noting only "approximately 1 percent of all civil cases filed in federal court are resolved by trial."); *see also id.* at 33 (noting that "the prohibitive costs of hiring a lawyer to handle those disputes, have contributed to the decline of trials.").

they handled cases; and 2) ended up acting in accordance with these stories, sometimes more than once. In those cases, I had to act in manners less casual and easy-going than with counsel where there is a good relationship, and more of a formalized, following rules-to-the-letter politeness, a lesson I was taught by one of my law professors as a first-year student. For example, instead of using first names, counsel in those cases will always be "Mr./Ms. Counsel" and nothing else. That is because I cannot trust that being more than that minimal level of civil will not end up hurting, either my client or myself as an attorney. There is a part of me that definitely feels sorrow for those moments, given the number of attorneys I have met and worked with who do not act that way.

WHAT HAPPENS AT THE INTERSECTION OF THE LAW, DUTIES TO CLIENT, WORKING WITH THIRD PARTIES SUCH AS EXPERTS OR INTERNAL PERSONNEL, AND CIVILITY? WHAT KIND OF INTERSECTION IS IT AND HOW DO YOU HANDLE IT?

NG: Being an attorney can be a true juggling act. An attorney is required to be a fiduciary and advocate for clients, a colleague with opposing counsel, a seeker of social justice, and a custodian to the court.[29] In addition, some attorneys may also be involved in their firm operations which include administrative tasks, marketing, and a host of other hats as well. Further, with ever-changing technology, it seems that communication has only sped up with emails, text messages, social media, and other mediums. The demands of an attorney sometimes come at the cost of civility. Although I do not have any sage advice on the proper approach to handle the workload, my approach has been to surround myself with as strong of a team as possible and continue to be transparent with my clients, the court, and opposing counsel to the extent possible.

MC: There is a balancing act that occurs when you are trying to manage those potentially conflicting interests at that point, and the risk is throwing civility aside to accomplish the goals of the client. There is not a one-size-fits-all approach in these cases, in part because of the individual personalities that exist. As a lawyer, you could be trying to act as a go-between for different groups from

29. *See* MODEL RULES OF PRO. CONDUCT, pmbl. ¶¶ 1, 2, 5, 6, 9, 10 (AM. BAR ASS'N 1983).

your own client[30] while at the same time, dealing with opposing counsel and their arguments. You have to learn to communicate in different methods, depending on who you are dealing with. Again, the key is to remember the best practices of civility and keep putting them to use.

WHAT ARE YOUR BIGGEST PITFALLS TO CIVILITY AS A PLAINTIFF/DEFENSE ATTORNEY?

NG: Individually, my biggest pitfall to civility is to not become "over-vested" in a case. As stated before, over-vesting may cause attorneys to become more emotional due to an individual pressure to win instead of advocating for the client. This can lead to losing composure and civility in the process. My primary legal practice is one where my clients typically rely on my experience and expertise to determine a fair settlement or conclusion on the case. However, I often found myself pushing for a position only to find that the client was willing to settle at a much less aggressive position. Over time, I have found more importance in communicating with clients on their goals and positions in advance to ensure we advocate their positions correctly. This also helps maintain composure with opposing counsel since you are advocating your client's position instead of your own.

MC: One of the biggest pitfalls is listening to what other people tell you about opposing counsel. It can be a trap. With an us versus them mentality, adversarial tactics can easily be justified at the expense of civility. At the same time, if the opposing counsel acts in a manner that fits every description you have been given, how much of a trap does it become? A massive one, in fact. I even resort to reminding myself of phrases such as "strive mightily, but eat and drink as friends"[31] and "the better angels of our nature" (as a hard lesson from history) as ways to remind myself that even if the opposing attorney will not act in a civil manner, then it is incumbent on me to strive even more to do so.

30. An example would be taking policy directives from client executives and relaying them to internal technical staff and ensuring legal compliance is accomplished while hearing and attempting to resolve the frustrations of the staff, whether those frustrations are directed internally or towards opposing parties.

31. William Shakespeare, *The Taming of the* Shrew, Act. I, sc. 2. This is a lesson learned from years of being a part of the American Inns of Court and the civility practices encouraged there.

HOW MUCH OF A ROLE DOES KNOWING OPPOSING COUNSEL PLAY IN YOUR CASE ANALYSIS?

NG: Most attorneys work in a field where they meet certain opposing counsel regularly. In my practice area, we often will know opposing counsel even before we file the petition to the court. Knowing opposing counsel typically *does not* affect the case analysis prior to filing the lawsuit, but it *does* impact the case preparation once the lawsuit is filed. Some opposing counsel understand the overall goal that all parties are seeking to achieve whereas others tend to take a more technical approach to the law. Although neither is improper, knowing opposing counsel is important on how to handle a case.

MC: A decent amount if I actually know the opposing counsel. I can tell whether it is run-of-the-mill or whether this will involve something unique that will take more effort than other cases. In getting to know opposing counsel over time, I learned that some attorneys seemed to take on cases that would be challenging, and that knowledge is useful, especially when I have a good relationship with that person. In fact, in a practice where I would see the same plaintiffs and attorneys in subsequent years, I got to know instinctively whether a case would be problematic or not. For example, this got to a point of common practice with some opposing counsel where attorneys and internal client representatives would agree to mediate cases at the outset of the litigation. This came from hard experience, knowing the challenges both sides would have and how, in prior years, delaying mediation made things more difficult for both sides.

WHAT DO YOU DO IF YOU DO NOT KNOW THE OPPOSING COUNSEL?

NG: It is important to open up the lines of communication with new opposing counsel as soon as practicable. The conversation can be about the case issues, but more often it is to build a connection as two colleagues in the same profession. This concept again goes back to not seeing opposing counsel as an adversary, but instead a colleague that is serving an adversarial interest.

MC: If I do not know the opposing counsel, I start with politeness and a little humor. Sometimes a little self-deprecation can open a door, even when it is not factual. Ask questions—that is one of the things we are trained for: investigating. Ask questions as though you were getting to know them as a person, and for no other reason than that. Before you know it, you will likely have found some things in common and there is a lot you can build off with that. Hobbies, cooking, foods, restaurants, where they like to travel, whether they have kids—these help you get past some of the ingrained adversarial stance and build a better relationship.

WHAT ARE THE INITIAL STEPS YOU TAKE WHEN YOU GET A NEW CASE AS A PLAINTIFF/DEFENSE ATTORNEY?

NG: A vast majority of the lawsuits filed in my firm are from clients that we have previously worked with administratively or in prior litigation. For those, conflict checks and conforming with Texas Disciplinary Rules of Professional Conduct Rule 3.01 are fairly straight-forward.[32] However, for new claims that arrive at our desk, we begin with a quick conflict check and a more detailed internal review of the claims made by the individual. If we determine the claims are frivolous or not in line with our understanding of the law, we decline engagement.[33] For example, we have had potential clients attempt to use an incorrect valuation methodology or use a methodology that goes against the generally accepted appraisal practices to defend their position. In these situations, although it would not be against the disciplinary rules to accept the case, our firm has chosen to not engage such properties. Once we confirm these two areas, we complete a more thorough conflict check and engage the client for the appeal.

MC: Two-fold. One is the basic case analysis process. What kind of case is it, what are the issues, what are the immediate risks I can tell from the initial pleadings and file? I am lucky in that the tax litigation I do helps hem the scope of many potential issues, but as in any practice, you will be faced with some curveballs now and again. The second step for me is finding out whether I am dealing with someone who is represented. If they are, do I know the opposing counsel?

32. TEX. DISCIPL. RULES OF PRO. CONDUCT r. 3.01 (ST. BAR OF TEX. 2022).
33. MODEL RULES OF PRO. CONDUCT r. 3.1 (AM. BAR ASS'N 1983).

HOW DOES CIVILITY INTERACT WITH THIRD PARTIES?

NG: The purpose of law is to get to the correct social justice outcome. Although that statement is as difficult to accomplish as it is vague, it seems to be the overall goal of law. The reason this can be difficult is that not everyone has the same definition of social justice, or the "socially proper" result may not be in the interest of that individual or entity. As such, it is the attorney's job as advocate and counselor to speak to their clients and potential clients about the possible risks, benefits, and the law even if it is against the client's interest[34]. As mentioned earlier, the field that I work in has a 60-day statute of limitation,[35] which is far quicker than most other lawsuits. Often, I will receive a call from a potential client that is beyond the 60-day statute. In those situations, I must inform them there is nothing that can be done because they are statutorily barred from proceeding in the lawsuit. Most of them tend to argue with me that it is unjust and unfair that they are not getting their right to proceed with their claims. In those situations, I cannot afford to lose my civility even if their argument is futile. Instead, I must empathize with their position and hope they understand the predicament they are in is not something that can be fixed.

MC: Interacting civilly with third parties is a must as an attorney, especially one who represents tax authorities. Attorneys are not popular in the public eye. Taxes are not popular in the public eye. Both play vital roles. So, when I am dealing with third parties, my role is to ensure that civility is a regular practice. I want them to come away with a good impression, both that the client and their representative (myself included) are doing good and responsible work. This goes to some of the core requirements of the MRPC.[36] Acting in accordance with the rules does not change depending on who I am dealing with, or whether I am acting as a lawyer in that moment. If I am at a restaurant enjoying a night off, taking photographs on a road trip, or playing drums at a jam session, I am still a lawyer underneath it all and my underlying conduct and behavior has to be in accord with the rules I am sworn to uphold.

34. *See* MODEL RULES OF PRO. CONDUCT r. 2.1 cmt. 1 (AM. BAR ASS'N 1983).
35. TEX. TAX CODE § 42.21(a) (2022).
36. *See* MODEL RULES OF PRO. CONDUCT r. 4.4(a) (AM. BAR ASS'N 1983).

WHAT ARE YOUR PERSONAL ORIGINS OF CIVILITY?

NG: My origins of civility come from my parents, specifically my father. My parents owned a restaurant in California and later a hotel in Texas. I always admired how much respect my father gave to everyone he met, including customers, employees, vendors, and others. It was by watching him that I saw it was not only possible, but crucial to balance being firm about your business decisions while remaining civil with others. I specifically remember a customer that came into our hotel one night with a reservation that we did not have. I remember him yelling at my father for wrongfully cancelling the reservation and how he did not have anywhere to go. After what seemed like 30 minutes of complaining, all while my father stood and empathized with the patron, my father asked him to look up the phone number that they called. It turned out that the number was for another hotel in town and my father promptly provided him with directions to that property. The interesting thing about this story is that I asked my father why we did not provide a room when the customer needed one and we had rooms available. My father responded that it would not be fair to the other hotel that had the reservation. It was here I learned that civility is not something that is meant arbitrarily but should be shown to everyone, even competitors.

MC: When I think about civility, I think about my parents and their jobs. More specifically, my father, who was a school district administrator. Early in my life, he taught me lessons about how he interacted with people in ways that I have adopted over my own career. For example, one of his lessons came from something he learned—if he had the chance, he re-arranged his office so that the desk was not between where he sat and where any visitor would sit. He learned that clearing space and removing the desk allowed for better communication, as there were no impediments between him and whomever he needed to talk to. Another lesson he taught me has some very direct implications when I am called on to provide advice on or help create policy of some sort. He taught me that he would at least include and consider, even if he would not adopt, positions which he disagreed with and, in many cases, found deeply distasteful to himself personally. As he said, if you cannot at least hear these ideas, even if they will be rejected, then any decision made cannot be said to have been fair.

One of the most important lessons I learned as a young lawyer came from an experience I had working as a volunteer law clerk at the Minnesota Tax Court. I watched a short trial conducted by Judge Raymond Krause. On one side was an assistant attorney general, armed with all the litigation paperwork he needed. The opposing party was pro se, who had no paperwork, no files, documents or anything, having lost them in a fire. Legally, the ultimate decision was obvious once the trial had concluded. As we were leaving the courtroom, Judge Krause pulled me aside and asked me, "Why do you think we did that?" I don't remember what I said, though I probably attempted something intelligent. He said "We did that because it gave him the opportunity to be heard. We gave him the respect of listening to his arguments in court and the chance to be heard and to say what he needed to say, even if the law was not in his favor. He might know that he will not win, but he is leaving knowing that he was given that respect and opportunity to be heard." That lesson stuck with me and has affected me in many ways. Often, a client or opposing party, especially unrepresented parties, are dealing with a system that frustrates and stymies. Many times, my role is as a counselor in those circumstances–letting them talk and say what they need to say. Someone willing to listen and not interrupt, who can at least empathize with their frustrations while using this as an opportunity to help them understand why the law is what it is in this particular circumstance, whether it helps them or not. One of the biggest benefits that comes from acting in this manner is that it helps create a better understanding and appreciation of the rule of law, and if my being patient helps with that, so much the better.

HOW DO YOU TEACH CIVILITY? DOES IT MAKE A DIFFERENCE WHO IS LEARNING THE LESSON?

NG: Speaking from my reference point only, I believe civility can only be taught by example. I highly doubt there can be enough situational examples to put in a book to cover all aspects of civility. Overall, it is a mindset and a choice that can only be learned by witnessing. Much like a language or other skill, I do feel that younger individuals have a better chance of grasping civility than older individuals; however, civility is a lesson that is open to anyone willing to learn. In addition, I do not think civility is a skill that is ever fully mastered. I feel that everyone should always strive for civility, but also be open to improve when possible.

MC: I cannot speak for how we each individually learn, but I think civility has the benefit of being taught by examples, whether positive or negative. The ethics opinions are rife with negative examples, as are the news stories of attorneys behaving badly in discovery, depositions, or in court. Sadly, you do not get many reported positive examples. Those, I think, come more from personal experiences and lessons, such as those passed on by professors, judges, and mentors. I hate to think that the adage “it’s hard to teach an old dog new tricks” is true, and I personally push myself to keep learning in ways I had not before. That is certainly required under the Rules of Professional Conduct anyway—for example as a lawyer, I have to keep up with changes in technology[37]. There is no reason I also cannot keep up with my own growth both as a person and as a lawyer and use that to keep improving my own best practices for civility.

“BOWLED OUT” – A CONCLUSION

Lord’s Middle Ground was only utilized for a few years before the “New” ground was fully adopted for use in 1814.[38] Just as in many professions, including sports, lawyers come and go from firms or agencies, and attorneys on opposing sides will find themselves dealing with new attorneys.

There are a few commonalities between ending a cricket match (or any professional sporting match) and the conclusion of a lawsuit. Both sides post-mortem review what happened. Questions are asked regardless of the result. If successful, “What worked? How can we refine and improve? What takeaways do we have for future references?” If unsuccessful, “What went wrong? Why? What can we change? How can we improve? What actions caused harm, and can we change things so they do not happen again?” Teams seek to improve from game to game, as do lawyers from case to case. The process of growth and civility continues over time, for those who take it on themselves to continue it in their own profession and persons. Just like maintaining legal education with continuing education, attorneys can maintain and improve their

37. MODEL RULES OF PRO. CONDUCT r. 1.1 cmt. 8 (AM. BAR ASS’N 1983).
38. Marleybone Cricket Club, *Our History*, LORD’S, https://www.lords.org/mcc/the-club/our-history (last visited Dec. 19, 2023).

civility by adopting new best practices and becoming better from case-to-case, year-to-year, and over the course of their careers. Unlike certain sports, there is no end to a season or off season for attorneys, so practicing civility is a skill that always has room for growth. That being said, the adversarial nature of the legal profession should not be an excuse to substitute civility. Instead, we may live in a time where civility is more needed in the legal profession than ever before.

For both of the authors, appreciating the game of cricket was the starting middle ground on a long professional relationship where civility was the key element, no matter how adversarial a case was. Even on the challenging cases, the friendly banter and sledging[39] that each side participated in came from that base of civility. While numerous cricket terms could be used to describe portions of a case in litigation, and even the reverse, it is essential to understand that civility and professionalism is the focus and the ability to keep growing civility is a key part of that. As cricketeer and Test Captain Alastair Cook said, "No matter how much cricket you have played, you are always learning."[40] This can also equally be applied to the practice of law, as no matter how much civility you practice, you are always learning. After all, in both worlds—cricket and law— nobody wants to have a negative reputation ascribed to them over "verbal spray."[41]

39. *Glossary of Cricket Terms*, WIKIPEDIA, https://en.wikipedia.org/wiki/Glossary_of_cricket_terms (last visited Dec. 19, 2023); *Sledging*, WIKIPEDIA, https://en.wikipedia.org/wiki/Sledging (last visited Dec. 19, 2023).

40. George Dobell, *Cook Aims for 'Remarkable' Ashes Glory*, ESPNCRICINFO (June 26, 2015), https://www.espncricinfo.com/story/alastair-cook-aims-for-remarkable-ashes-glory-891627; Ali Martin, *Alastair Cook's Ashes Optimism Fired by Feelgood Factor after NZ Series*, THE GUARDIAN (June 26, 2015), https://www.theguardian.com/sport/2015/jun/26/alastair-cook-england-ashes-feelgood.

41. Justin Robertson, *'Dibbly Dobbly','French Cut','Bunny' and Other Cricket World Cup Terms you Should Know by Now*, YAHOO SPORTS (Feb. 26, 2015), https://sports.yahoo.com/blogs/eh-game/-dibbly-dobbly---french-cut--and--bunny---here-s-28-world-cup-cricket-terms-you-should-know-by-now-193033965.html.

THE TAX INEFFICIENCY OF "PROOF OF STAKE" BLOCKCHAIN REWARDS

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1. Bill Najmy is a member of the Florida bar, practicing law in Tampa Florida. In 2020, Bill graduated from Stetson University College of Law, earning his Juris Doctor, and then in 2021 from the University of Florida Levin College of law earning an LL.M in the laws of taxation. Bill works with clients in all areas of tax and business transactions, and is proud to have had the opportunity to advise several clients regarding the tax results of using cryptocurrency as part of their business structure.

I. INTRODUCTION

Cryptocurrency has been one of the hottest and least understood financial topics of the last decade, and as of Q4 of 2022, the total asset value of the entire cryptocurrency market was over one trillion dollars.[2] Cryptocurrency is a scarce, valuable, intangible form of digital property that is held by the taxpayer on a computer;[3] however, it cannot be removed from the blockchain network on which it was created.[4] It is regularly bought and sold on an open market, and the fair market value of any unit of cryptocurrency is derived through the traditional economic notions of supply and demand.[5] Buying and selling on the open market also creates a fluctuating fair market value and high price volatility.[6]

Despite the "currency" name, cryptocurrency in the United States is not characterized as a currency for tax purposes.[7] Notwithstanding several failed attempts by Congress[8], no federal laws have been passed that seek to manage the use, trade, purchase, sale, or exchange of cryptocurrency for tax purposes. Instead, the IRS established a tax policy by publishing Notice 2014-21, which requires that all cryptocurrencies be characterized as property for tax purposes, and as such, the taxation principles related to property transactions have become the rules that govern cryptocurrency transactions.[9] Notice 2014-21 and an accompanying Frequently Asked Questions page published by the IRS are the cornerstone of guidance for US taxpayers when

2. D. Towne Morton, *The Future of Cryptocurrency: An Unregulated Instrument in An Increasingly Regulated Global Economy*, 16 LOY. UNIV. CHI. L. REV. 129, 129 (2020); Jordan Pritchett, *Cryptocurrency: An Overview*, 134 BANKING L.J. 547, 547 (2017); Cristina Polizu, PhD, et al., *A Deep Dive into Crypto Valuation*, S&P GLOBAL (Nov. 10, 2022) https://www.spglobal.com/en/research-insights/featured/special-editorial/understanding-crypto-valuation.

3. David Rodeck, *Digital Currency: The Future of Your Money*, FORBES (Feb. 16, 2023), https://www.forbes.com/advisor/investing/cryptocurrency/digital-currency/.

4. *Id.*

5. *See* Morton, *supra* note 2; Andrew Bloomenthal, *What Determines Bitcoin's Price?*, INVESTOPEDIA, https://www.investopedia.com/tech/what-determines-value-1-bitcoin/ (updated May 11, 2022).

6. Anshu Siripurapu & Noah Berman, *Cryptocurrencies, Digital Dollars, and the Future of Money*, COUNCIL ON FOREIGN REL. (Feb. 28, 2023), https://www.cfr.org/backgrounder/cryptocurrencies-digital-dollars-and-future-money

7. Notice 2014–21, 2014–16 I.R.B. 938 [hereinafter Notice].

8. S*ee generally* Blockchain Innovation Act of 2020, H.R. 8153, 116th Cong. (2020); The Digital Taxonomy Act of 2019, H.R. 2154, 116th Cong. (2019); and The Token Taxonomy Act of 2018 and 2019, H.R. 7356, 115th Cong. (2018), H.R. 2144, 116th Cong. (2019).

9. Notice, *supra* note 7.

treating cryptocurrency as a capital asset and reporting the tax consequences of any related transactions.[10]

The most important set of rules relating to the taxation of cryptocurrency in the United States are found in Notice 2014-21.[11] First, that cryptocurrency is to be treated like property,[12] and second, which instances of cryptocurrency received by a taxpayer, through "mining" or other non-purchasing receipt events, should, or should not, be recognized as income to that taxpayer at the time of receipt.[13] For example, IRS FAQ Q-23 explains that any cryptocurrency received as part of an "airdrop" due to a blockchain hard fork (a non-purchasing receipt event) is income, whereas IRS FAQ Q-31 states that any cryptocurrency received as a bona fide gift (a non-purchasing receipt event) is not income.[14] The Notice, and its previously mentioned rules, make logical and rational sense on their face; however, as technology has progressed and taxpayer activity has moved far beyond simple buy and sell transactions, it has become clear that the simple taxing principles related to property transactions are no longer adequate for managing the new and intricate ways taxpayers have begun to engage with cryptocurrency and the blockchain ecosystems.

One such area, and the focus of this Article, is the block verification and endorsement rewards received by taxpayers who participate in a proof of stake blockchain network.[15] The mechanics of how a "proof of stake blockchain network" works are discussed below, and the related tax inefficiency and characterization lies in Question 8 of the Notice, which states:

> *Q-8: Does a taxpayer who "mines" virtual currency (for example, <u>uses computer resources</u> to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?*

10. *Frequently Asked Questions on Virtual Currency Transactions,* IRS, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated July 26, 2023) [hereinafter FAQs].
11. Notice, *supra* note 7.
12. FAQs, *supra* note 10.
13. *Id.*
14. *Id.*
15. Notice, *supra* note 7.

> A-8: Yes, when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income.

The purpose of this Article is to show, through an analysis of the applicability of Question #8, that, when drafted, the policy in Notice 2014-21 was likely reasonable, but almost a decade later, that reasonableness can no longer hold true. While the development of new technology is often inspired by old, new technology also seeks to solve existing problems in novel ways. Software developers, whether involved in blockchain or elsewhere, build software with the intent to solve those new problems, and not to comply with tax law.[16]

Because the Notice characterizes cryptocurrency as property for tax purposes, this Article will abandon the typical currency related terms found in other analyses, such as coin or token, and instead refer to the cryptocurrency as units of property and cryptocurrency property. For the most part, this Article will assume the reader is generally familiar with the concepts behind cryptocurrency and blockchain technology.[17]

II. THE BASIC CONCEPTS OF PROOF OF WORK V. PROOF OF STAKE

Although digital forms of fiat currency do exist, such as central bank digital currency[18], cryptocurrency property cannot exist without a blockchain network,[19] and all of the transactions and transactional data is stored on its underlying blockchain: a never-ending chain of verified blocks of information.[20]

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16. *See* Kindra Cooper, *Problem-Solving in Software Engineering: An Inside Look*, SPRINGBOARD BLOG (Jan. 20, 2020), https://www.springboard.com/blog/problem-solving-in-software-engineering-an-inside-look/. ("[S]oftware engineers are tasked with designing features and applications that may not even exist yet").

17. Brian Ray, *Blockchain Symposium Introduction: Overview and Historical Introduction*, 67 CLEV. ST. L. REV. 1, 1-21 (2019).

18. Board of Governors of the Federal Reserve System, *FAQ on Central Bank Digital Currency (CBDC)*, FED. RESERVE (Aug. 3, 2023), https://www.federalreserve.gov/cbdc-faqs.htm.

19. Scott Likens, *Making Sense of Bitcoin, Cryptocurrency, and Blockchain*, PWC FINTECH, https://www.pwc.com/us/en/industries/financial-services/fintech/bitcoin-blockchain-cryptocurrency.html (last visited July 17, 2023).

20. William Kleindienst, *Bitcoin, Blockchain, and Cryptocurrencies: A Legal Perspective*, 33 S.C. LAW 50, 52 (2022).

From a high-level perspective, there are two main methods for verifying and storing any data on a blockchain system: proof of work and proof of stake.[21] Both use a network of decentralized contributors to verify the new data, create new blocks of data, and record that data onto each newly created block.[22] In return, the contributors at all levels, including block endorsement and verification, receive new units of cryptocurrency property as reward for their participation in moving the blockchain forward.[23] Under both methods, the contributors who participate often pool their resources together in order to have a better chance at earning a block reward.[24] These resource pools are generally organized by combining either the computing power of many individuals,[25] or the cryptocurrency ownership stake of many individuals.[26]

While each approach seeks the same result, each has different requirements and methods to reach their goal.[27] The proof of work method, where the term "mining" virtual currency comes from,[28] which was the focus of Notice 2014-21[29] uses specialized computers to solve complex cryptographic problems, resulting in the verification and recording of new data onto the blockchain and the distribution of new cryptocurrency property rewards to the contributors.[30] This process is resource intensive, both in its upfront capital investment to purchase the specialized computer equipment, as well as the energy consumption costs for running and cooling the equipment.[31]

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21. Ameer Rosic, *Proof of Work vs Proof of Stake: Basic Mining Guide*, BLOCKGEEKS, https://blockgeeks.com/guides/proof-of-work-vs-proof-of-stake (updated Oct. 18, 2022).
22. *Id.*
23. *Id.*
24. *What are Mining Pools: The Massive Cooperatives that Power Blockchain,* PHEMEX (Oct. 15, 2021), https://phemex.com/academy/what-are-mining-pools.
25. *Id.*
26. *See* Rosic, *supra* note 21. Under proof of stake, the owners pool their cryptocurrency ownership together. The more stake that is aggregated together, the more opportunities for verifying and endorsing blocks, and earning rewards, that pool will get.
27. *Id.*
28. Brian Baker, *What is Bitcoin mining and how does it work?*, BANKRATE (Mar. 27, 2023), https://www.bankrate.com/investing/what-is-bitcoin-mining/.
29. *Id.*
30. Peter Van Valkenburgh, *What is Bitcoin mining, and why is it necessary?*, COIN CENTER (Dec. 15, 2014) https://www.coincenter.org/education/advanced-topics/mining.
31. Corrie E. Clark & Heather L. Greenly, *Bitcoin, Blockchain, and the energy sector,* CONG. RSCH. SERV., R45863, BITCOIN, BLOCKCHAIN, AND THE ENERGY SECTOR (2019) (energy cost depends on the proximity to power generation and location).

Furthermore, in a proof of work network there is an effective conflict of interest between two distinct groups of taxpayers.[32] Except when engaging in a transaction on the network, a taxpayer who only holds units of cryptocurrency property from a proof of work blockchain does not benefit from the "mining" process, and conversely, a taxpayer only engaged in "mining" is not required to own any units of cryptocurrency property from that blockchain at any given time.[33] Though they are separate in their roles, the taxpayer engaged in the mining process can be thought of as an advanced mode participant, while the taxpayer who only holds cryptocurrency property can be thought of as a simple mode participant.

In that way, a proof of stake blockchain network also has two levels of participation in the form of the advanced mode and the simple mode. Under proof of stake both the advanced mode and the simple mode users are able to participate in the verification and recording of new data onto the blockchain, and as such, both are able to receive the rewards as a result.[34] While not completely without some work involved, the advanced mode user must have some level of technical expertise and skill to operate and maintain a network server, —known as a node,[35] —while the simple mode only requires the taxpayer to own a personal computer or a smartphone.[36]

Unlike the proof of work network, both the advanced and simple mode users of a proof of stake system must have a "stake" in the network by owning a portion of that network's cryptocurrency property. The simple mode user often only delegates their stake to an advanced mode user, like a stock voting proxy.[37] The more stake allocated to the node, determined by a

32. Rosic, *supra* note 21.

33. *Id.*

34. E. Napoletano, *Proof of Work Explained*, FORBES (Feb. 16, 2023), https://www.forbes.com/advisor/investing/cryptocurrency/proof-of-work/#:~:text=Proof%20of%20work%20is%20a,the%20integrity%20of%20new%20data.

35. *What is a Node in Crypto?,* SENSORIUM (Sept. 14, 2022), https://sensoriumxr.com/articles/what-are-nodes-in-crypto.

36. *Id.* The cost of running a node, while significantly less than a proof of work setup, still requires costs, such as internet, electricity, server hardware. Most people own a smartphone anyway to participate as a simple mode user.

37. Coinbase, *Delegating Digital Assets 101*, COINBASE (Jan. 9, 2021), https://www.coinbase.com/cloud/discover/solutions/delegating-digital-assets. (delegation of cryptocurrency property gives all the rights associated with ownership to another person or entity, but not the title of ownership to another person or entity).

combination of the node owner's stake and its delegates' stake, the more opportunities that node will have to earn rewards.[38]

In this way, unlike proof of work, both types of stakeholders can participate in the proof of stake blockchain network for relatively low investment cost.[39] This ease of entry, coupled with the broad ability for participation, is the reason that the future of blockchain is moving towards the proof of stake method,[40] and it is why it is important for the United States to establish policies under the tax law and other regulations to foster growth, rather than stifle innovation.

A. Does This Relationship Create a Tax Partnership?

The joint activity by a stake-pool operator and its delegates opens a question about what is actually going on between an advanced mode user and simple mode user under the proof of stake system, and whether they are engaged in a tax partnership.[41] The advanced users, who expressly avails themselves of the proof of stake network by setting up a node, could be engaged in a business activity. While the simple mode user, who only delegates his stake to the node but does not manage the node or pay for expenses, is more likely engaged in a passive activity.[42] In that regard, this activity could create an implied limited partnership. Though not necessary for the formation of a common law partnership, an implied limited partnership is an unlikely result because the Revised Uniform Limited Partnership Act of 1997, adopted by more than half of the states according to the Uniform Law Commission, requires a filing of a certificate of limited partnership with an office of a state's Secretary of State.[43]

Furthermore, while both types of users are deploying their stake as a resource to receive the rewards, a tax partnership

38. *Id.*

39. *Id.*

40. *Id.*

41. 26 C.F.R §301.7701–3 (2020) (requires that a partnership first be a business entity). This activity cannot be a partnership under this definition because it is not a business entity, and it is entirely possible for those involved to have never met one another, or that they live in different countries.

42. *See* Comm'r v. Groetzinger, 480 U.S. 23, 36 (1987) (citing Higgins v. Comm'r, 312 U.S. 212, 216) (determination of an active trade or business requires an examination of the facts in each case).

43. P'SHIP ACT (1985) ACT § 201 (1985) (creating a significant problem for cross border cooperation).

cannot be the case because the two are only sharing in the pro rata receipt of property; there is no shared expenses,[44] and never any shared losses.[45]The two types of users do not pool their resources to buy property together or to pay other service providers, and the pledged stake by one type of user does not affect the property rights of the other. Only the advanced mode user can legally claim title to the hardware of a node,[46] but if either type of users sustain any losses resulting from the cryptocurrency property losing appreciated value, that user's loss will not affect the other.[47] If the advanced mode user sustains losses through operating the node, and as a result, the activity is no longer economical, that user will simply shut down the node hardware and the simple mode user will find a different node operator to delegate their stake.[48]

B. Cryptocurrency Compared to Other Valuable Property

Receipt of new cryptocurrency property by the taxpayer is somewhat similar to the earned interest a taxpayer receives for money or other assets held by a financial institution. In that case, the taxpayer receives the interest payment in return the financial institution's ancillary deployment of the cash or other assets it holds on the taxpayer's behalf, generally in the form of loans. On the other hand, with the proof of stake blockchain network there is no ancillary deployment of the crypto property, and the network generates and distributes new property to the taxpayer, which the taxpayer did not previously have, simply because the taxpayer own

44. Madison Gas & Elec. Co. v. Comm'r, 633 F.2d 512, 517 (7th Cir. 1980) (separates startup costs for each entity reflects a partnership). Here, the simple mode user has no startup costs and is not engaged in an active trade or business.

45. 26 C.F.R §301.7701–3(b)(2) (2020). Two or more persons are engaged in digging a ditch. None of their individual resources are comingled, and each is free to come and go as they please with no repercussions. This matches the relationship between the advanced and simple users.

46. *See* REV. UNIF. PART. ACT § 301 (UNIF. LAW COMM'N 1997). (Members operating in the cooperative effort who hold themselves out to third parties as conducting business as a single unit). Only the advanced mode user has a duty to attract new members to the activity pool or to interact with third parties at all. Simple mode has no control over the operation.

47. While I.R.C. §7701(a)(1) (1999) has a broad definition that includes the term "pool", and under the related regulations a partnership may be formed without formal designation, there is still no financial tie between anyone cooperating here.

48. While there are privately controlled pools that protect who join and who leaves, generally, unlike §601 REV. UNIF. PART. ACT (2020–2021 ed.), which requires notice of withdrawal from a partnership, there is no requirement either user ever notifies the other that they are no longer choosing to participate with each other.

units of that property to begin with and participates in moving the blockchain forward.

A wrinkle in the already challenging analogy is apparent when we observe that there is no standard way that these systems operate their networks or deploy and distribute their networks. rewards. Some networks require that the simple user must expressly choose to participate, such as the Tezos and Cardano blockchains,[49] while others like the VeChain and Algorand blockchains, require that all users must always participate.[50] Some blockchains calculate and give the simple and advanced user their rewards relatively frequently; for instance the Tezos blockchain rewards are distributed every three days,[51] while others do not track or give the rewards at all until the user makes an express request for them to be calculated and distributed.

Both the Cardano blockchain, which accumulates rewards every five days, and the Cosmos blockchain, which accumulates rewards every few seconds, require that the taxpayer must expressly elect to have their rewards distributed.[52] In that regard, when using a system where the taxpayer must expressly request their rewards to be distributed, it should be clear that the taxpayer does not have dominion and control over the property before the distribution is completed.[53] Nonetheless, without clear guidance, the answer is not so obvious. The taxpayer will always have the ability to make the distribution request, but without making that request, the taxpayer cannot do anything with the property.[54]

49. The Tezos and Cardano blockchains require the users to expressly participate.

50. Users of the VeChain and Algorand blockchains are made to automatically participate simply by owning the property.

51. The Tezos blockchain creates a reward every three days and distributes the reward the user automatically.

52. The Cardano blockchain accumulates rewards every five days, whereas the Cosmos blockchain accumulates rewards every few seconds. Both require the user to expressly request the rewards to be distributed to them.

53. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (gross income includes "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

54. FAQs, *supra* note 10, at A–24 (a taxpayer has dominion and control over cryptocurrency they can transfer, sell, exchange, or otherwise dispose of).

C. The Relationship between Blockchain Networks and Cryptocurrency

This discussion is important for the future of cryptocurrency and blockchain technology because while Bitcoin was the initial catalyst that caused the cryptocurrency revolution,[55] the usefulness of Bitcoin's underlying blockchain is quite limited.[56] In fact, it can only do one thing: record the transactions of the Bitcoin cryptocurrency.[57] Newer blockchains, which tend to be proof of stake, are more akin to decentralized software platforms whose cryptocurrency property serve to support the underlying functions and operations.[58]

This ability to build useful software applications on top of a blockchain network quashes the biggest critical arguments that there is no inherent or underlying value to the property and that speculative investment is the only price driver.[59] As new blockchain-based software applications grow in acceptance, it is clear that the utility of the blockchain network itself will back the underlying value of any cryptocurrency property, rather than the speculative investor activity.

III. PROOF OF STAKE AND TAX INEFFICIENCY

Under accepted tax principles, when a taxpayer buys any unit of property, the amount the taxpayer paid for that property is the property's tax basis.[60] At a later time if the property is sold; the tax basis is subtracted from the amount realized from that sale to

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55. *See* Likens, *supra* note 19.

56. Nathan Reiff, *Bitcoin vs. Ethereum: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/articles/investing/031416/bitcoin-vs-ethereum-driven-different-purposes.asp (updated Oct. 4, 2022).

57. *Id.*

58. Carlo R.W. De Meijer, *Blockchain Technology Challenges: New Third-Generation Solutions*, FINEXTRA (Feb. 28, 2021), https://www.finextra.com/blogposting/19949/blockchain-technology-challenges-new-third-generation-solutions (third generation blockchains seek so solve issues of scalability, privacy, and utility).

59. Jennifer Sor, *Crypto Has Little Intrinsic Value or Fundamentals to Fall Back On, and Traders Are Merely Riding A 'Hot Ball of Momentum' Investment Firm Says*, MKT. INSIDER (Jan. 12, 2023), https://markets.businessinsider.com/news/currencies/crypto-market-hot-ball-theory-momentum-trading-intrinsic-value-skeptic-2023-1.

60. I.R.C. § 1012(a) (2000) ("The basis of property shall be the cost of such property."); I.R.C. §1011(a) (2000) ("The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis . . . adjusted as provided in I.R.C. section 1016.").

calculate any profit or loss.[61] Like traditional forms of property, cryptocurrency property is subject to these same mechanics because of the policy set forth in Notice 2014-21.[62] Even still, there are other areas in the cryptocurrency and blockchain ecosystem that can be used to highlight the ways Notice 2014-21 is no longer sufficient. For example, Notice 2014-21 is incapable of providing guidance on how to determine the tax treatment of a taxpayer's use of smart contracts,[63] or whether the creation and sale of artwork and other digital media, in the form of a "non-fungible token," are a collectibles.[64]

For the purchase of a unit of cryptocurrency property, the basis is easy to find, it is simply the cost paid for the quantity of cryptocurrency purchased.[65] Like other forms of property, the taxpayer should treat each purchase of cryptocurrency as a single and discrete unit of property, with its own tax basis.[66] Thus, it is important for a taxpayer to keep track of the tax bases for each unit cryptocurrency property purchased in order to maintain proper records, and for determining the actual gain or loss realized on any future dispositions.[67]

However, at the time Notice 2014-21 was drafted staking rewards were not considered, and mining virtual currency, found in Question #8.[68] of the Notice, is the closest analogy to make.[69] Because there is no guidance related specifically to proof of stake,

61. I.R.C. § 1001(a).

62. Lee A. Sheppard, *Cryptocurrency Customer Compliance*, *in* TAX NOTES FED. 709 (Nov. 4, 2019), https://www.taxnotes.com/tax-notes-today-federal/cryptocurrency/cryptocurrency-customer-compliance/2019/11/04/2b32c (that simple fact remains that the IRS has a disconnect between their ability to regulate and what taxpayers are doing).

63. Stuart D. Levi & Alex B. Lipton, *An Introduction to Smart Contracts and Their Potential and Inherent Limitations*, HARVARD L. SCH. F. ON CORP. GOVERNANCE (May 26, 2018), https://corpgov.law.harvard.edu/2018/05/26/an-introduction-to-smart-contracts-and-their-potential-and-inherent-limitations (a smart contract is a computer code that automatically executes all or parts of an agreement and is stored on a blockchain-based platform; however, they are rarely a true contract in the traditional legal sense as we know them).

64. Ryan Browne, *People are Paying Millions for Clips that can be Viewed for Free. Welcome to the World of 'NFTs'*, CNBC (Mar. 3, 2021), https://www.cnbc.com/2021/03/03/what-are-nfts-all-you-need-to-know-about-crypto-collectibles.html ("[N]on-fungible tokens, are a new type of digital asset. Ownership of these assets are recorded on a blockchain . . . Each NFT is unique and acts as a collector's item that can't be duplicated . . . ").

65. I.R.C. § 1012(a), *supra* note 60.

66. FAQs, *supra* note 10, at Q–40.

67. *Id.* at Q–39.

68. Notice, *supra* note 7.

69. Notice, *supra* note 7.

the safe reporting method is that each staking reward received by a taxpayer is taxable income for an amount equal to the fair market value of the quantity of property received, at the time the taxpayer received it.[70] This treatment of staking rewards inferred by a combination of the Rev. Rul. and Notice 2014–21 Q–8 (virtual currency mining).

The inefficiency of this policy as it relates to proof of stake rewards reaches a point of convergence with the mechanics of property transactions when analyzed against the frequency that taxpayer receives these proof of stake rewards. After the taxpayer receives the new property and recognizes income, the fair market value of the property at the time of its receipt becomes the tax basis by which the amount realized in a future sale or disposition will be calculated for future gains and losses.[71] Those mechanics, coupled with the lack of uniformity across each system and the market conditions that create a fluctuating fair market value over time, is where the heart of the inefficiency lies.[72]

70. Rev. Rul. 2019–24, 2019–44 I.R.B. 1004 (Oct. 9, 2019) (receipt of cryptocurrency property by "airdrop",
i.e., not from purchase, bona fide gift, or exchange for value, is included in gross income).

71. I.R.C. § 1001(a) *supra* note 61.

72. *See* Bloomenthal, *supra* note 5.

Timestamp	Unit Received	FMV @ Timestamp	Cost Basis	Unit Current Value	Gain/Loss
6/25/20 3:41 AM	0.329029	$ 2.54	$ 0.84	$ 1.02	$ 0.18
6/28/20 12:21 AM	0.345892	$ 2.30	$ 0.80	$ 1.07	$ 0.28
6/30/20 9:01 PM	0.233874	$ 2.37	$ 0.55	$ 0.73	$ 0.17
7/3/20 5:41 PM	0.214652	$ 2.30	$ 0.49	$ 0.67	$ 0.17
7/6/20 2:11 PM	0.102269	$ 2.37	$ 0.24	$ 0.32	$ 0.07
7/9/20 10:51 AM	0.098187	$ 2.58	$ 0.25	$ 0.30	$ 0.05
7/13/20 11:54 AM	0.224553	$ 3.08	$ 0.69	$ 0.70	$ 0.00
7/15/20 10:46 AM	0.217195	$ 2.96	$ 0.64	$ 0.67	$ 0.03
7/18/20 1:51 AM	0.27387	$ 3.12	$ 0.85	$ 0.85	$ (0.01)
7/20/20 10:25 PM	0.140597	$ 2.80	$ 0.39	$ 0.44	$ 0.04
7/23/20 6:58 PM	0.233839	$ 3.20	$ 0.75	$ 0.72	$ (0.02)
7/26/20 3:31 PM	0.351099	$ 3.00	$ 1.05	$ 1.09	$ 0.04
7/29/20 12:05 PM	0.197834	$ 2.88	$ 0.57	$ 0.61	$ 0.04
8/1/20 8:39 AM	0.095196	$ 2.91	$ 0.28	$ 0.30	$ 0.02
8/4/20 5:21 AM	0.099421	$ 3.14	$ 0.31	$ 0.31	$ (0.00)
8/7/20 2:03 AM	0.224106	$ 3.25	$ 0.73	$ 0.69	$ (0.03)
8/9/20 10:51 PM	0.405936	$ 3.72	$ 1.51	$ 1.26	$ (0.25)
8/12/20 7:37 PM	0.254414	$ 4.25	$ 1.08	$ 0.79	$ (0.29)
8/15/20 4:19 PM	0.428053	$ 4.15	$ 1.78	$ 1.33	$ (0.45)
8/18/20 1:05 PM	0.262343	$ 3.99	$ 1.05	$ 0.81	$ (0.23)
8/21/20 9:38 AM	0.238469	$ 3.80	$ 0.91	$ 0.74	$ (0.17)
8/24/20 6:39 AM	0.141861	$ 3.73	$ 0.53	$ 0.44	$ (0.09)
Totals	**5.11**		**$ 16.30**	**$ 15.85**	**$ (0.45)**

Total Units Received	Cost Basis	If All Sold @ FMV	Gain Or Loss
5.11	$ 16.30	$ 15.85	$ (0.45)

The chart above is an example of what proper accounting looks like when tracked over time. This chart uses a cryptocurrency whose hypothetical current fair market value is $3.10. Through a hypothetical sale by the taxpayer of each of the discrete units of property received over time, gain and loss is calculated using the past fair market at the time of the property's receipt and the current fair market value of the property at the time of the hypothetical sale.

The historical fair market value is often difficult to determine after the fact.[73] It is important to note that a "virtual currency miner" operating on a proof of work blockchain would need to keep

73. There are various services available to help taxpayers find this information, but it is still time consuming if not done in real time. *See Historical Prices*, COIN MARKET CAP (last visited Jun. 18, 2023), https://coinmarketcap.com/historical; This can also be inferred by the fluctuating fair market value, *see* Bloomenthal, *supra* note 5.

similar records for later selling their mining rewards, but when considering the initial resources required to participate under proof of work, that activity is closer to an active trade or business, and that taxpayer would likely be expected to keep more accurate records.[74] The inefficiency under proof of stake happens because, as noted above, everyone who holds units of that type of property can engage in the system in a much more passive way.[75] With the value of any unit of the property derived from the fair market value of each unit found on the open market, existing outside of the system itself, a simple user could find themselves in an unintended forensic accounting nightmare.[76]

A. Addressing the Inefficiency and Other Concepts

Through the relationships described above, we can see that the tax inefficiency of Notice 2014-21 is a result of the price fluctuation related to market supply and demand, coupled with the potential for hundreds of instances of income realization events.[77]As shown, tracking the recognized income is not as simple as keeping track of purchased assets, the earned interest from a savings account, or the dividends received from owning stocks.[78]

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74. Justin Woodward, *IRS Guidance on Cryptocurrency Mining Taxes*, TAXBIT (Jun. 3, 2021), https://taxbit.com/blog/2019-10-21-irs-guidance-on-cryptocurrency-mining-taxes/ (some frequent expenses that may be eligible for the trade or business expense deduction include mining equipment, electricity costs, repairs, and rented space used to operate the equipment).

75. *See* Rosic, *supra* note 21.

76. The example above uses real data for the proof of stake endorsement rewards I received from the Tezos blockchain network from June to August of 2020. Like most people, when I started participating in that system, I was not considering the tax consequences of the reward property received, or how to track the tax basis for gain and loss on any future disposition. Having identified this problem, and not finding a satisfactory product already on the market, I created a tool to automate the tax basis calculation, and have published it for public use at https://backtobasis.tax.

77. *See* Rosic, *supra* note 21.

78. *See* Coinbase Tax Resource Center, COINBASE, https://help.coinbase.com/en/coinbase/taxes-reports-and-financial-services/taxes/coinbase-tax-resource-center (last visited Jun. 18, 2023) (Coinbase, one of the largest US based cryptocurrency exchanges, issues its customers 1099-MISC forms under limited circumstances, but never issues 1099-B forms); Adam Barone, *Form 1099-INT: Interest Income Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/f/form-1099-int.asp (updated Feb. 8, 2021); Adam Barone, *Form 1099-B: Proceeds from Broker and Barter Exchange Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/f/form-1099-b.asp (updated Feb 8, 2021). As explained in these two articles, taxpayers are given reports for income earned through interested and income earned through brokerage services. However, there is no general reporting requirement or information return requirement for cryptocurrency transactions.

The latter three are measured in dollars, whereas cryptocurrency rewards are always received as new property.

When laid out in this way the relationship is clear to see. Under the right circumstances, a hypothetical taxpayer could let accumulated rewards go untouched for years; only to sell them later when the historical fair market value has changed so frequently that determining basis is almost an impossible task. Unless a taxpayer chooses to do so, under real world conditions, little ties any one taxpayer to their blockchain activity.[79] The eventual sale back to fiat currency is the exit point for any cryptocurrency, and that is where the blockchain activity is generally linked to the taxpayer.[80]

Nonetheless, it is a completely valid argument to say that if a taxpayer chooses to engage in this activity, that taxpayer is responsible for accurate record keeping. When considering that these systems are designed to escape the traditional financial markets and transactional tracing mechanisms, under the current policy rules, some taxpayers may simply choose to not comply with the reporting policy rather than engage in forensic price tracking and accounting.[81]

B. Income Recognition from Staking Rewards

At the forefront of the challenge to the IRS and Notice 2014-21, as it relates to proof of stake rewards, is Abraham Sutherland and his 2019 publication, *Cryptocurrency Economics, and the Taxation of Block Rewards Parts 1 & 2*.[82] Sutherland specifically

79. John Bohannon, *Why Criminals Can't Hide Behind Bitcoin*, SCIENCE (Mar. 9, 2016), https://www.sciencemag.org/news/2016/03/why-criminals-cant-hide-behind-bitcoin. If a person were to purely keep their transactions on the blockchain, they could be untraced, but eventually the cryptocurrency property will need to be sold for cash. Liking to an exchange account to a bank account is the easiest way authorities can link a person to a cryptocurrency address.

80. Some companies like Bity allow taxpayers to pay their bills using bitcoin or other cryptocurrency property. However, the company requires proper identification to do so. *See generally* Pay Bills Online with Crypto, BITY (last visited Jun. 18, 2023), https://bity.com/products/crypto-online-bill-pay/.

81. Bohannon, *supra* note 79 (though not impossible, people will still take the easy route).

82. Abraham Sutherland, *Cryptocurrency Economics and the Taxation of Block Rewards*, 165 TAX NOTES 749 (Nov. 4, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3466796 [hereinafter Sutherland Part 1]; Abraham Sutherland, *Cryptocurrency Economics and the Taxation of Block Rewards*, 165 TAX NOTES 953 (Part 2; Nov. 11, 2019),

analyzed the consequences of proof of stake rewards against other types of passive income by analyzing how the Tezos blockchain works for the advanced mode users.[83] Sutherland argues that when a taxpayer participates in the proof of stake blockchain data verification process, the instances of cryptocurrency property they receive as a reward are not only new property, but they are units of self-created property.[84] Sutherland contends that when these rewards are looked at for "what they actually are", Notice 2014-21 deviates from generally accepted tax principles relating to income from property transactions because it is instructing that this self-created property should be recognized as income upon their creation, whereas other forms of self-created property require a subsequent sale of the property to generate an income realization event.[85]

While the Sutherland argument is strong, his "self-created property" theory still tries to create a one-size-fits-all rule based on the activity of a single blockchain network, Tezos, in the same way that Notice 2014-21 did by only considering Bitcoin.[86] As previously explained, there is no standard way that software developers solve their design problems when creating any software.[87] When the mechanics of the many different blockchains are analyzed, it becomes clear that the processes from system to system lack a uniform way to account for the proof of stake rewards received by a taxpayer, and how they are distributed between the advanced mode user and the simple mode user.[88]

In an email conversation with Keefer Taylor, co-founder of the blockchain engineering firm Tessellated Geometry, LLC, Taylor explained that the items paid out from the proof of stake rewards on the Tezos blockchain are made up of both new property and network transaction fees.[89] As the use of the network grows, so will the quantity of transaction fees that are included as part of the

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https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3466796. (hereinafter Sutherland Part 2].

83. Sutherland Part 1, *supra* note 82, at 755. Sutherland hangs his entire argument on the way the Tezos blockchain works, barely mentioning the many other blockchain networks that utilize proof of stake.

84. Sutherland Part 2, *supra* note 82, at 964.

85. *Id.*

86. *See* Sutherland Part 1, *supra* note 82.

87. Cooper, *supra* note 16; De Meijer, *supra* note 58.

88. *See* Glenshaw Glass Co., *supra* note 53.

89. E-Mail from Keefer Taylor, Co-Founder, Tessellated Geometry, to author (Mar. 3, 2021) (on file with author).

rewards.[90] To Sutherland's credit, at the time of his publication the proportion of the reward made up of newly created property was significantly greater than the proportion made up of transaction fees; as the use of this blockchain continues to grow, so will the proportion of the reward that is made up of fees.[91]

Logically then, to follow Sutherland's self-created property theory to its conclusion will require an analysis of each reward received, including all of the different ways that each system handles its reward distribution, to determine which portion of the units may contain self-created property and which portion is made from transaction fees. Thus, in accepting that self-created property theory, we would find ourselves in a situation that is as equally complex as Notice 2014-21 is inefficient. Though Sutherland's argument that proof of stake rewards are not income upon receipt have merit,[92] the self-created property theory as a unifying characterization is simply not on point.

Notwithstanding that Sutherland's argument fails to include an important nuance of the rewards system the blockchain network that he specifically analyzed, the "self-created property" theory is simply unable to account for the many ways that the many proof of stake systems facilitate their distribution of various rewards.[93]

C. Diluted Stake Ownership Resulting from Rewards

Similarly, Sutherland's *Taxation of Block Rewards* explores the idea of a dilution in value of each taxpayer's overall stake in any proof of stake blockchain by the rewards earned.[94] Using an analogy based on *Eisner* v. *Macomber*,[95] Sutherland asserts that there is no actual gain in wealth over time because the percentage of ownership never changes, similar to a corporate stock split.[96] Sutherland uses a formula to chart out why the assertion is correct;

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90. *Id.*
91. *Id.*; Sutherland Part 1, *supra* note 82.
92. 26 C.F.R. § 1.61-4(a) (2023). The farm method of accounting allows a farmer to not recognize income until crops or other farm products are sold. Here, though cryptocurrency property is not new or self-created, there is precedent for other types of property where the taxpayer puts in efforts to get new property, such as farm products, to only recognize income on future disposition.
93. Taylor E-mail, *supra* note 89.
94. Sutherland Part 1, *supra* note 82, at 760.
95. Eisner v. Macomber, 252 U.S. 189 (1920).
96. Sutherland Part 1, *supra* note 82, at 762.

however, his point is ultimately moot because the exercise is one that does not match the way an individual unit of cryptocurrency property achieves a fair market value.[97]

The well-known definition of *fair market value* is the price a willing buyer would pay to a willing seller in an arm's length transaction,[98] and each cryptocurrency unit's fair market value is derived through exactly that definition. Interestingly, at the time of *Macomber*, the shares of United States Oil Co. (Standard Oil), the company whose stock was at the heart of the case, traded only privately.[99] However, in Sutherland's dilution analysis, the concept that each unit of property derives its fair market value from its trade on an open market is missing.[100] Instead, Sutherland presents an idea where the blockchain network itself has static value, and the units of cryptocurrency property thereof derive value by in proportion to the aggregate network value, similar to how the shares of a closely held corporation derive their value from the aggregate value of all existing stock of the company.[101]

While it is a generally accepted concept that proof of stake rewards creates a dilution of the circulating supply of property, and therefore the systems are inflationary,[102] failing to take notice of the actual mechanics of the real-world activity makes little sense.[103] When analyzed in the proper light, the underlying network derives its value from the aggregate value of all of the underlying cryptocurrency property outstanding. In fact, one of the most important metrics to many taxpayers involved in the cryptocurrency markets is the value of each network's market

97. Bloomenthal, *supra* note 5.

98. Bank One Corp. v. Comm'r, 120 T.C. 174, 308 (2003). Fair market value, though not expressly defined in the tax code, generally requires (1) that a willing buyer and willing seller be aware of all the facts relevant to the value of property, and (2) neither the buyer or seller be under compulsion to buy or sell the property in question.

99. Brian Taylor, *The First Billion-Dollar Company*, INV. OFFICE (Nov. 15, 2017), https://www.investmentoffice.com/Observations/Markets_in_History/The_First_Billion-Dollar_Company.html ("One of the more interesting aspects of the dissolution was that even though Standard Oil was the biggest corporation in the world in 1911, its shares were not traded on the New York Stock Exchange. Shares only traded over the counter or on the New York Curb.").

100. Sutherland Part 1, *supra* note 82, at 762.

101. *Id.*

102. *Id.*

103. Thomas Lee Hazen, *Tulips, Oranges, Worms, and Coins – Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J.L. & TECH. 500, 508 (Apr. 2019). While it makes sense to give cryptoassets capital gains treatment, the notion that a common enterprise in cryptoassets exists between everyone holding a piece of the cryptoasset should be rejected.

capitalization.[104] Thus, if the fair market value of a single unit is $3.10, and the network generates 30 units of property from proof of stake rewards, those new units will retain $3.10 as their fair market value, regardless of any dilution.

After all, the purpose of challenging the IRS policy of Notice 2014-21 is to push the tax policy in a direction that more closely matches taxpayer activity. The fact of the matter is that when a taxpayer receives their staking reward, they can immediately sell that unit of property on the open market, bringing to fruition the income recognition concept that Notice 2014-21 attempts to capture.

In that way, it does not matter that any rewards received by a taxpayer dilute the taxpayer's aggregate ownership percentage if the fair market value per unit is the metric for which gain, or loss, is recognized and that fair market value not affected by the occurrence of a reward distribution. Hence, if Notice 2014-21 is rationally correct in its characterization of cryptocurrency as property, and its required recognition of income at the time of receipt, can the inefficiency alone, when compared to actual taxpayer activity and expectation, warrant a drastic change of policy?

The answer to that question should be a resounding "YES!" While it is true that the IRS has the authority to enforce the policies established by the agency itself,[105] it is also no secret that due to a lack of budget, the IRS is currently having trouble keeping up with even its standard tax collection and enforcement duties.[106] Therefore, to meet taxpayer expectations in a way that will encourage compliance, there needs to be a broad-based legislative investigation and enactment of true statutory rules and regulations relating to blockchain, cryptocurrency, and the entire spectrum of related transactions. From my experience, most taxpayers want to comply, but they also do not want to be in a

104. Jason Fernando, *Market Capitalization: How Is It Calculated and What Does It Tell Investors?*, INVESTOPEDIA, https://www.investopedia.com/terms/m/market capitalization.asp (Mar. 16, 2023).

105. I.R.C. § 7801(a) (2018) (noting that the Powers of the Department of Treasury to enforce Title 26 of the United States Code); I.R.C. § 7803(a)(2) (2022) (outlining the duties of the Commissioner of the Internal Revenue Service.).

106. Jessica Lucas-Judy, *More Delays Ahead—Pandemic Continues to Slow Down IRS*, U.S. GOV'T ACCOUNTABILITY OFF. (Mar. 25, 2021), https://www.gao.gov/blog/more-delays-ahead-pandemic-continues-slow-down-irs (Covid-19 impacted the IRS in the same ways that most private businesses were impacted, employees were sent home. This further slowed down the already complex activity of processing tax returns).

situation where the rules make compliance burdensome and confusing.

IV. CHANGES THAT FIT IN THE REAL WORLD

As discussed above, it is not possible to create an all-encompassing rule by simply focusing on only one blockchain system.[107] Each developer builds, manages, and operates their system differently, and what may work for one, such as Sutherland's arguments based off the Tezos blockchain, will likely create unforeseen complications for others. Though many taxpayers may disagree, the truth of the matter is at the time of publication, the IRS was technically correct with Notice 2014-21. However, when applied to real world changes that have taken place since that time, the Notice creates a taxing mechanism that is essentially taxation by brute force, rather than precision.

A. Other Areas of Inefficiency in Cryptocurrency and Blockchain

Though this Article examines proof of stake reward systems as the primary example of the inefficiency of Notice 2014-21, there are many other activities taking place on many blockchains and decentralized software that are simply beyond the scope of this Article.[108] The prime example of such activities falls under an umbrella term known as "decentralized finance", or Defi.[109] The activities happening within Defi range from leveraged positions, to assent lending, and even synthetic interest-bearing savings accounts.[110] While we may draw analogies for these activities to traditional notions of finance, "smart contracts" control these activities,[111] and the operations, aside from deposit and withdraw,

107. Morton, *supra* note 2.

108. Mayank Sahu, *8 Interesting Ethereum Project Ideas & Topics for Beginners*, UPGRAD BLOG (Jan. 3, 2021), https://www.upgrad.com/blog/ethereum-project-ideas-beginners/. Software to exchange property, games, casinos, credit access for small businesses, NFTs.

109. Kenneth Rapoza, *What's the Big Deal About DeFi and How do you Invest in It?*, FORBES (Mar. 21, 2021), https://www.forbes.com/sites/kenrapoza/2021/03/21/whats-the-big-deal-about-defi-and-how-do-you-invest-in-it/?sh=43f30b6fe89c ("Decentralized finance . . . refers to digital, peer-to-peer financial services technologies that permit crypto trading, loans, interest accounts, and other services. It is reliant on public blockchains like Ethereum and cryptocurrencies.").

110. *Id.*

111. Levi & Lipton, *supra* note 63.

happen in a way that has been designed to shield the true activity from the view of the taxpayer in the first place.[112]

Some of these activities, and their merit as financial devices, are questionable at best, and more akin to gambling at worst; however, they raise other novel questions. For example, should a leveraged position that uses cryptocurrency property as collateral, and which pays out another type of cryptocurrency property as a loan, receive the same treatment as a traditional loan? Assuming the loan has a sufficient interest rate, it is normal for traditional loans to use property as collateral; the lender usually distributes cash to the borrower, not other property. Another, and one of the most interesting, is the concept of cryptocurrency property that has a fair market value pegged to the value of an outside source, such as fiat currency, and intended for use as a traditional fiat currency, colloquially known as stablecoins.[113]

B. Notice 2014-21 is No Longer Reasonable under U.S. v. Mead Corp.

The IRS is simply not able to create a complex taxing regime on its own, and "The Congress may not delegate its purely legislative power to a commission, but, having laid down the general rules of action under which a commission shall proceed, it may require of that commission the application of such rules to particular situations and investigation . . . "[114] Congress has not yet created a statutory and legal framework to authorize a taxing power over cryptocurrency property and blockchain transactions; to do so would be outside of the delegated authority that the IRS has as an administrative agency. When Congress confers decision making authority upon agencies Congress must "lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform.[115] The limits of an administrative agency to conduct its activities are outlined in the Administrative Procedure Act (the "APA") which sets the limits of an administrative agency to conduct its activities.[116] Three cases,

112. *Id.*
113. Lennart Ante et al., *The Influence of Stablecoin Issuances on Cryptocurrency Markets* 1-2 (Blockchain Rsch. Lab, BRL Working Paper Series No. 11, 2020).
114. J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 408 (1928).
115. Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 472 (2001) (quoting *J.W. Hampton*, 276 U.S. 394 at 409).
116. Administrative Procedure Act, 79 P.L. 404, 60 Stat. 237, 79 Cong. Ch. 324 (1946).

Chevron, U.S.A., Inc. v. NRDC, Inc.[117]; *Skidmore v. Swift & Co.*[118]; and *United States. v. Mead Corp*, have each famously tested the APA and its limits.[119] First, *Chevron* deals with the regulatory interpretation of statutes.

"When a court reviews an agency's construction of the statute which it administers, . . . [the first question is] whether Congress has directly spoken to the precise question at issue."[120] Here, Congress has enacted no statutes, and therefore there is no legislation to carve out a delegation of power to the Treasury and the IRS to create a complex taxing regime for cryptocurrency property transactions.[121]

"Good administration of the Act and good judicial administration [of agency rules] alike require that the standards of public enforcement and those for determining private rights shall be at variance only where justified by very good reasons."[122] Second, this area also falls outside of the purview of *Skidmore* because if there are no statutes to interpret, then there are also no other regulatory rules for the Treasury and IRS to follow related to cryptocurrency transactions either. One of the most important factors in dealing with cryptocurrency taxation is that Notice 2014-21 is a policy stance the IRS has chosen to take; the choice that cryptocurrency is property is not actual law.[123]

Considering the situation at hand, the IRS acted independently when it decided on the policy position published in Notice 2014-21. Therefore, the issue must be analyzed in light of *United States* v. *Mead Corp*. "Congress, that is, may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap. Yet it can still be apparent from the agency's generally conferred authority and . . . that Congress would expect the agency to be able to speak with the force of law."[124]

Under the *Mead* ruling, Congress enacted legislation to enforce tariffs on trading partners, carving out a delegation of

117. Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837 (1984).
118. Skidmore v. Swift & Co., 323 U.S. 134 (1944).
119. United States v. Mead Corp., 533 U.S. 218 (2001).
120. *Chevron*, 467 U.S. at 842.
121. *See* Notice*, supra* note 7 (all cryptocurrency and blockchain legislation that failed in Congress).
122. *Skidmore*, 323 U.S. at 140.
123. Various failed legislative packages, *supra* note 7.
124. *Mead*, 533 U.S. at 229.

power to the United States Customs Service to set which import items would be subject to certain tariffs.[125] In its ruling, the Court noted that Congress was not going to get involved in the technical details of characterizing each item imported through US ports of entry, and in doing so found that so long as the USCS made its designations properly and with due process, the agency should be given deference in those decisions because that was the entire point in delegating powers to administrative agencies.[126]

Here, there is a similarity from the perspective of the policy choices made in 2014. At that time, Bitcoin was the only cryptocurrency receiving any significant public attention,[127] and as such could neatly fit into a *Mead* issue.[128] The IRS has been delegated the power to collect taxes by Congress, but Congress has not delegated a specific statutory power to tax cryptocurrency or blockchain activity. Through the analysis of *Mead*, it is clear that Notice 2014-21 is a reasonable extension of the previously delegated power, despite no specific delegation of power.

When the IRS was formulating the notice between 2012 and 2014, many people still assumed Bitcoin was a blip in the social radar that would eventually die out.[129] The price was fluctuating between $200 and $800, and it looked like the whole thing could just be another fad that would disappear as quickly as it came.[130] History, on the other hand, has shown that has not been the case.[131] Though Bitcoin itself has not changed, public perception around cryptocurrency as a whole certainly has, including advanced financial instruments that track and derive their own value based on the cryptocurrency markets and bought and sold in traditional financial markets.[132]

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125. *Id.* at 222 ("Section 1502(a) provides that 'the Secretary of the Treasury shall establish and promulgate such rules and regulations as not inconsistent with the law. . . .'"). For the IRS, the same can be said to apply with I.R.C. § 7801.

126. *Id.* at 226.

127. Van Valkenburgh, *supra* note 30.

128. *Mead*, 533 U.S. at 218.

129. Dan Ashmore, *Bitcoin Price History 2009 to 2022*, FORBES, https://www.forbes.com/advisor/investing/cryptocurrency/bitcoin-price-history/ (Oct. 11, 2022).

130. *Id.* (Almost two years later, in April 2013, Bitcoin reached $200. By the end of November that same year, it was worth
more than $1,000. It then rose tenfold to $10,000 in November 2017.).

131. Rodeck, *supra* note 3.

132. John Rotoni, *What is Grayscale Bitcoin Trust?*, MOTLEY FOOL (Apr. 10, 2021),
https://www.fool.com/investing/2021/04/10/what-is-the-grayscale-bitcoin-trust/ (Grayscale is a trust, it's a fund which buys Bitcoin, and the shares of this fund are traded in the New

Though it is true that Notice 2014-21 was open to public notice and comment submissions, the entire cryptocurrency market has changed significantly since its publication.[133] Everyone, from institutional investment firms (and their big money) to retail investors with small savings are getting involved, and all want a piece of the action.[134] The simple power of the IRS to tax in this area because of the Congressional general delegation of a taxing authority can no longer be taken lightly. Those simple rules found in Notice 2014-21, meant to get ahead of a phenomenon no one understood, are no longer sufficient or reasonable on their own.

V. BETTER RULES MOVING FORWARD

There have been countless articles and publications written on how to create a better taxing regime for cryptocurrency.[135] With so much existing literature, I will only propose four solutions that can create a better policy for this activity, as well as meet taxpayer expectations.

First, buying cryptocurrency property for cash as a capital asset, and later sold should follow the regular capital asset sale rules. Second, when a taxpayer uses cryptocurrency property as a means of transferring value to purchase goods or services, regardless of whether the property has a fixed or fluctuating fair market value, that property should be treated as instantly sold and any appreciation in the property recognized as ordinary income.[136] Third, any other activity that happens on the blockchain, including proof of stake rewards, where the taxpayer receives some quantity of property through an action other than buying, should be disregarded at the time of receipt, and only characterized and recognized at a later time of sale for regular fiat currency. This future characterization method should disregard any historic fair market value of the property for tax basis purpose, and instead, tax any amount realized at a flat tax rate. Finally, any

York Stock Exchange. You can go to your broker and buy shares in this trust. By this way, you have exposure to Bitcoin because you know that this trust is backed by Bitcoin.).

133. Notice, *supra* note 7; Kasey Pittman and Michelle Hobbs, *The Ever-Changing World of Digital Asset Taxation*, BAKERTILLY (Oct. 25, 2022), https://www.bakertilly.com/insights/the-ever-changing-world-of-digital-asset-taxation.

134. Rodeck, *supra* note 3.

135. Sutherland Parts 1 & 2, *supra* note 82; Hazen, *supra* note 103.

136. If it is being used like cash, it should be treated like cash.

comprehensive change must include a de minimis threshold level to exclude minimal value activity from gross income.

VI. CONCLUSION

Notice 2014-21 and the rules that it sets forth have become significantly inefficient in dealing with the cryptocurrency and blockchain markets as they stand today, especially proof of stake network rewards. To that end, even the most prominent publication analyzing the proof of stake problem misses the mark when it comes to exploring how taxpayers use cryptocurrency property, how these blockchain systems are structured, and how those systems should be taxed.

However, given that the limited power delegated to the IRS does not include creating new taxing regimes, the policies described in Notice 2014-21 were reasonable at the time of their publication. Ultimately, an act of Congress will be necessary to create an efficient taxing regime that can account for the complex nuance created by this emerging industry.

AMERICA'S MOST HATED TAX?: WHY PROPERTY TAXES ARE UNFAIR AND REGRESSIVE TAXATION

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TABLE OF CONTENTS

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I. INTRODUCTION

Founding father Benjamin Franklin said in 1789, "nothing can be said to be certain, except death and taxes."[2] Even in a newfound country with a slim federal government found in part on anti-tax sentiment, the need for the government to bring in revenue was not in dispute. In the new United States, property taxes were some of the earliest taxes imposed, first being implemented on the federal level in 1798 (as well as locally around that same time).[3] Despite strong anti-feudal sentiments and being referred to as "free and common socage," property taxes endured through time because these taxes were typically both collected and spent locally on infrastructure valued highly by taxpayers.[4] While many bemoan their property taxes—which are known as "America's Most-Hated Tax"[5]—support of property taxation remains strong to this day for similar reasons.

Traditionally, the United States has moved towards progressive income taxes being a primary source of revenue for both the federal and many state governments, although that trend has slowed and even reversed in recent decades.[6] Yet, property taxes account for 72.1 percent of local tax collections and 31.9

2. Letter from Benjamin Franklin to Jean-Baptiste Le Roy, THE WRITINGS OF BENJAMIN FRANKLIN VOL. 10 (1856) at 410.

3. Alana Semuels, *The Feudal Origins of America's Most-Hated Tax*, THE ATLANTIC (Aug. 24, 2016), https://www.theatlantic.com/business/archive/2016/08/the-feudal-history-of-property-tax-in-america/497099/.

4. *See id.*

5. *Id.*

6. Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21 J. OF ECON. PERSP. 3, 22 (2007).

percent of all state and local tax collections in the United States.[7] While in theory, the incidence of property taxes should fall on those with more property, the reality of how governments impose property taxes often means that is not the case.[8]

To provide a rudimentary illustration of this concept: housing is a fundamental human need. Yet, someone who makes $100,000 likely does not spend four times as much of their income on housing as someone who makes only $25,000 per year, and someone who makes $1 million per year likely does not spend ten times as much of their income on housing as the person making $100,000 per year. Additionally, lower income people are more likely to rent than own their properties, and rental properties are typically subject to higher property taxes.[9] On top of that, most homeowners have a mortgage to finance their home ownership, while property taxes are generally based on market value of real estate and not a homeowner's equity.[10]

This paper seeks to investigate the true state of the regressivity of property taxes in the United States. This paper hypothesizes that property taxes are a regressive form of taxation, and that localities would be better served by other options if legally available to them and otherwise practicable. The paper will begin with an overview of the different types of property and local taxing schemes that exist in the United States and by explaining the rationale behind property taxes. From there, the terms "regressive tax" and "wealth tax" will be defined to communicate how property taxes act as a regressive wealth tax. Some of the regressive implications of property taxes, such as the impact on those with fixed incomes, during economic recessions, and access to affordable

7. Janelle Fritts, *To What Extent Does Your State Rely on Property Taxes*, TAX FOUNDATION (May 27, 2020), https://taxfoundation.org/state-property-tax-reliance-2020/.

8. *See* Wallace E. Oates & William A. Fischel, *Are Local Property Taxes Regressive, Progressive, or What?*, 69 NAT. TAX. J. 415, 417 (June 2016).

9. Drew Desilver, *As National Eviction Ban Expires, a Look at Who Rents and Who Owns in the U.S.*, PEW RSCH. CTR. (Aug. 2, 2021), https://www.pewresearch.org/fact-tank/2021/08/02/as-national-eviction-ban-expires-a-look-at-who-rents-and-who-owns-in-the-u-s/.

10. *See* John Wake, *U.S. Has 3rd Lowest Percentage of Households That Own Their Homes Without Mortgages*, FORBES (Mar. 31, 2023), https://www.forbes.com/sites/johnwake/2023/03/31/us-has-3rd-lowest-percentage-of-households-that-own-their-homes-without-mortgages/?sh=5c78ed443124; *see also* Michael Neal, *Mortgage Debt Has Peaked. Why Has the Share of Homeowners with a Mortgage Fallen to a 13-Year Low?*, URB. INST. (Aug. 20, 2019), https://www.urban.org/urban-wire/mortgage-debt-has-peaked-why-has-share-homeowners-mortgage-fallen-13-year-low.

housing, will be touched upon throughout this paper. While policymakers have attempted solutions towards addressing this regressivity, those solutions have often been incomplete or simply shifted the regressivity towards others. Finally, I will discuss some new policy proposals that seek to address this issue of regressivity and offer alternatives to property taxes.

II. AN OVERVIEW OF PROPERTY AND OTHER LOCAL TAXING SCHEMES IN THE UNITED STATES

The U.S. Constitution provides the power for the government to levy taxes. Article I, Section 8, Clause 1 states that "Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence [sic] and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."[11] This power has been interpreted to "embrace[] every conceivable power of taxation" at the federal level.[12] Historically, these taxes have included income taxes, wealth taxes, and tariffs among other things.[13] However, this broad power only applies to the federal government.

The U.S. Constitution does not impede the ability of states to impose most taxes. The 10th Amendment to the U.S. Constitution states, "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[14] In layman's terms, that means that matters not addressed by the U.S. Constitution are left to the discretion of the states. There are some exceptions to this autonomy of state governments to address their own taxing power, such as when state taxation interferes with interstate commerce, but property taxes, the focus of this paper, would seldom fall into that classification. Every state and the District of Columbia impose property taxes.[15]

11. U.S. CONST. art. I, § 8, cl. 1.
12. Brushaber v. Union Pacific Railroad Co., 240 U.S. 1, 12 (1916).
13. *A Short History of Taxes*, FORBES (Apr. 14, 2010, 2:42 PM), https://www.forbes.com/2010/04/14/tax-history-law-personal-finance-tax-law-changes.html?sh=6bca697a1cf8.
14. U.S. CONST. amend. X.
15. *How Do State and Local Property Taxes Work?,* TAX POL'Y CTR. (May 2020), https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-property-taxes-work.

While property taxes are typically imposed and collected by local governments, the powers of local governments are limited to those enumerated in their state's constitution and laws.[16] Dillon's Rule illustrates this concept, and states that local governments "may engage in an activity only if it is specifically sanctioned by the state government."[17] Thus, state governments can define the parameters within which local governments can collect taxes. While the U.S. Supreme Court upheld this philosophy, states often do sanction local governments to undertake a lot of responsibilities when it comes to taxation. [18]

Under the doctrine of "home rule," an authority granted by states to local governments, a local city or county can act autonomously in setting up a system of government and enacting local ordinances.[19] One model principle of home rule is the Local Fiscal Authority Principle, which states:

> Home rule should guarantee local fiscal authority and recognize the value of fiscal stability at the local level. This principle accordingly includes local power to raise revenue and manage spending consistent with local budgets and priorities. To support local fiscal authority, a state should ensure adequate intergovernmental aid for general welfare at the local level and be prohibited from imposing unreasonable unfunded mandates.[20]

Most states defer to Dillon's Rule over complete "home rule."[21] However, because Dillon's Rule enables states to give municipalities autonomy over certain things, many cities enjoy what is effectively "home rule" on a wide range of issues. Since

16. DANIEL R. MANDELKER ET AL., STATE AND LOCAL GOVERNMENT IN A FEDERAL SYSTEM 41–42 (5th ed. 2002).

17. *Cities 101—Delegation of Power*, NAT'L LEAGUE OF CITIES, https://www.nlc.org/resource/cities-101-delegation-of-power (last accessed July 22, 2023).

18. *See* Hunter v. Pittsburgh, 207 U.S. 161, 178–79 (1907); Trenton v. New Jersey, 262 U.S. 182, 186–87 (1923).

19. *Home Rule*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/home_rule (last accessed July 22, 2023).

20. Richard Briffault et al., *Principles of Home Rule for the Twenty-First Century*, Va. Pub. L. & Legal Theory Research Paper No. 2020-16 (Feb. 19, 2020), at 23.

21. As of 2016, 39 states officially employed Dillon's Rule to all municipalities and 11 employed "home rule" at least to some extent. *Local Government Authority*, NAT'L LEAGUE OF CITIES, https://web.archive.org/web/20160804131854/http://www.nlc.org/build-skills-and-networks/resources/cities-101/city-powers/local-government-authority (last accessed July 22, 2023).

"home rule" is given to localities by their state, it is not an absolute power. Notably, state governments have the power to preempt local laws. The role of preemption is growing, with the National League of Cities reporting that "[s]tate-level politicians are actively working to overturn the will of people in cities—both through preemption and Dillon's Rule provisions."[22]

As of 2017, forty-two states had some sort of preemption towards the power of local governments to tax.[23] As all states have property taxes, these preemptions do not prohibit property tax but rather address technicalities such as "elements of the revenue structure, including: cap on the property tax rate; limit on the growth in local property assessment; and/or limit on the total levy (revenue) growth from property taxes from year to year."[24] In fact, preemption of other forms of taxation often leave local governments with little choice other than to impose property taxes to raise sufficient revenue to pay for the local government's responsibilities.

III. THE RATIONALE OF PROPERTY TAXES

While we have established that property taxes are the predominant form of local government taxation, a more important question is why this is the case. Local governments have historically favored property taxes because they have been a rather stable source of revenue and because of the behavior they incentivize.

A. Property taxes allow people to "vote with their feet" on where to live.

The behavior incentivized by property taxes is best summarized by the Tiebout Hypothesis, first coined by economist Charles Tiebout in 1956.[25] The Tiebout Hypothesis can be summarized as stating:

22. Nicole DuPuis et al., *City Rights in an Era of Preemption: A State-by-State Analysis*, NAT'L LEAGUE OF CITIES 1 (Feb. 2018), https://www.nlc.org/wp-content/uploads/2017/02/NLC-SML-Preemption-Report-2017-pages.pdf.

23. *Id.* at 3.

24. *Id.* at 20.

25. *See generally* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. OF POL. ECON. 416 (1956).

> If there are a number of alternative communities (or jurisdictions) in which a consumer can choose to live and these differ in their provision of local public goods, then the consumer's choice of location provides a very clear signal of preferences. The chosen location is the one offering the provision of local public goods closest to the consumer's ideal, and through community choice preference revelation takes place. It follows that if there are enough different types of community and enough consumers with each kind of preference, then all consumers will allocate themselves to a community that is optimal for them and each community will be optimally sized. This ensures that the market outcome is efficient. It can be said that consumers reveal their preferences by "voting with their feet" and this ensures the construction of efficient communities.[26]

Essentially, Tiebout theorized that different local governments will attract different types of residents based on what services they decide to provide, and will tax their residents accordingly to provide those services. Anecdotally, there is some truth to this—for example, I grew up in a town with extremely high property taxes to sustain a public school system on par with private schools where nearly 100 percent graduated high school and went onto prestigious colleges. Because of this public school system, families with children decided to move to the town.

Grassmueck's findings support the Tiebout hypothesis, in that people tend to be attracted by higher levels of taxes and spending at the local level as long as they perceive a higher level of quality for the services they are being afforded.[27]

An additional rationale for property taxes is that property owners are "dependent" on the government to protect their property rights.[28] To protect their property, property owners depend on fire and police departments, as well as proper record keeping and a strong legal system, in order to protect and preserve their wealth.[29] After all, "rights are meaningless unless enforced

26. *Tiebout Hypothesis*, OXFORD REFERENCE, https://www.oxfordreference.com/view/10.1093/oi/authority.20110803104612771 (last accessed July 22, 2023).

27. Georg Grassmueck, *What Drives Intra-county Migration: The Impact of Local Fiscal Factors on Tiebout Sorting*, 41 REV. REG'L STUD. 119, 136 (2011).

28. Stephan Holmes & Cass R. Sunstein, *Why We Should Celebrate Paying Taxes*, CHICAGO TRIB., (Apr. 14, 1999), http://home.uchicago.edu/~csunstei/celebrate.html.

29. *Id.*

by government."[30] Meanwhile, a homeless person living on the streets, or even someone renting their home, does not receive this level of benefit.

While Tiebout's hypothesis offers a compelling market-driven narrative, the ability of people to "vote with their feet" on where to live is in fact far more limited. That is because of "realities such as limited job opportunities, consumer voters not having total knowledge of the choices of public goods in all communities, limits to mobility, moving costs, etc."[31] Saltz & Kapener assessed multiple variables that could drive people to migrate. They found, after analyzing the literature, that people are more likely to move to areas with more government services when it is a local move.[32]

While that trend is general for the population as a whole, it is reversed for those over 55; people over 55 are more likely to migrate to areas with lower property taxes.[33] Specifically, for the elderly, "$100 increase in annual property taxes is associated with a 0.73 percentage point increase in the two-year mobility rate for homeowners over the age of 50.[34] This is an 8 percent increase from the baseline two-year mobility rate of 9 percent."[35] This trend would be rationalized under Tiebout's model because in theory, elderly residents likely are not reliant on services typically funded through property taxes like public schools.[36] However, the reality is far more complicated, as certain assumptions (such as people being fully mobile, being able to choose between communities freely, and commuting costs) are easier said than done for most people, including those who may be more statistically mobile.[37] Additionally, there are noneconomic reasons why people live where they do; for example, many people seek to be near family, friends, certain recreational activities, high-quality healthcare, and the list goes on and on.

The "benefit principle of taxation" bases taxes to pay for public-goods expenditures on a politically-revealed willingness

30. *Id.*
31. Ira S. Saltz. & Don Capener, *60 Years Later and Still Going Strong: The Continued Relevance of the Tiebout Hypothesis*, 46(1) J. OF REG'L ANALYSIS & POL'Y 72, 73 (2016).
32. *Id.* at 74.
33. *Id.* at 75.
34. Hui Shan, *Property Taxes and Elderly Mobility*, 67 J. OF URB. ECON. 194, 194 (2010).
35. *Id.*
36. Saltz & Capener, *supra* note 32, at 75.
37. *Id.* at 76–78.

to pay for benefits received.[38] That is because the level of taxation "help[s] determine what activities the government will undertake and who will pay for them."[39] This concept is fairly similar to the Tiebout Hypothesis, as it essentially means that people are willing to pay more in property taxes when they perceive a value in the benefits received from them, and those that will not get those benefits can "vote with their feet" accordingly.

B. Property taxes are efficient.

Because there is a finite and fixed amount of land, many believe that makes property taxes a very efficient tax.[40] In his hallmark work *The Wealth of Nations*, Adam Smith noted that land value increases are generally not created by any action of a landowner, and therefore the resulting rents[41] and other monetary gains[42]:

> are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth and revenue of the great body of the people, might be the same after such a tax as before.[43]

While Smith's reflection dealt with a more agrarian society where much of income was generated off of land, there is merit to

38. *See generally* Graeme S. Cooper, *The Benefit Theory of Taxation*, 11 AUSTL. TAX F. 397 (1994).

39. *Taxation—The Benefit Principle,* BRITANNICA, https://www.britannica.com/topic/taxation/The-benefit-principle (last accessed July 22, 2023).

40. Kyle Pomerleau, *A Property Tax is a Wealth Tax, but . . .* , TAX FOUND. (Apr. 30, 2019), https://taxfoundation.org/property-tax-wealth-tax/.

41. "Thanks to the work of Smith and his intellectual successor David Ricardo, 'rent' has for economists come to have the specific meaning of unearned income from a resource whose supply is fixed. Or something like that. By that definition, income from land ownership other than rent payments (capital gains from selling land that has appreciated in value, for example) also amounts to 'rent.'" Justin Fox, *Why Economists Love Property Taxes and You Don't*, BLOOMBERG (Nov. 28, 2017, 7:00 AM), https://www.bloomberg.com/opinion/articles/2017-11-28/why-economists-love-property-taxes-and-you-don-t#footnote-1511307967325.

42. *Id.*

43. Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 693 (The Elec. Classics Series, 2005).

this argument. The appreciation of real estate value is considered "unearned income" akin to any other income generated from investments.[44] When realized, appreciation of real estate value would be taxed as capital gains, which are currently taxed at a more favorable rate than wages.[45] Additionally, realized appreciation on primary residences is often exempted from capital gains.[46] Of course, Smith's analysis differs from realities over the evolution of the industrialized economy and the current tax code.

While Smith's argument regarding the efficiency of property taxes may be obsolete in certain ways—namely because other taxing structures are in place and valuing real estate includes a multitude of factors—there is still an efficiency argument to be made. In most places in the United States, there are relatively strong records of property data that can be utilized.[47] That leads to property taxes in the United States having a rather high "coverage ratio."[48] Additionally, there are strong legal mechanisms such as liens which make them collectable, thus yielding a high "collection ratio."[49] While "[p]roperty taxation is a very administrative-intensive tax which requires proactive, intentional tax base identification, tax base valuation, tax liability assessment, tax billing and collection, tax enforcement, and taxpayer service and dispute resolution,"[50] the strong legal structure and recordkeeping

44. *See generally* Lester B. Snyder, *Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?*, 18 VA. TAX REV. 241 (1998).

45. *How are Capital Gains Taxed?*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed (last accessed July 22, 2023).

46. *Topic No. 701 Sale of Your Home*, IRS, (Jan. 27, 2023), https://www.irs.gov/taxtopics/tc701.

47. Roy Kelly, *Making the Property Tax Work*, 4 INT'L CTR. FOR PUB. POL'Y, Working Paper no. 13-11, 2013, https://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1041&context=icepp, at 4.

48. "The Coverage Ratio (CVR) is defined as the amount of taxable property captured in the tax registry, divided by the total taxable property in a jurisdiction. This ratio measures the completeness of the tax roll information and is determined by the administrative efficiency of identifying and capturing property data using field surveys, secondary property information, and/or taxpayer-provided information, and ensuring the correct application of legally approved exemptions, reductions and tax relief policies." *Id.* at 6.

49. "The Collection Ratio (CLR) is defined as the annual tax revenue collected over total tax liability billed. This ratio measures collection efficiency on both current liability and tax arrears, determined largely by political will, taxpayer service and the effective use of incentives, sanctions and penalties." *Id.*

50. *Id.* at 14.

of the United States leads many analysts to conclude it to be an efficient tax.[51]

C. Property taxes are a relatively stable source of revenue, even during recessions.

"The property tax had always been regarded as an excellent revenue source for local governments because of its stability."[52] Hayashi described property taxes as either "countercyclical," which means "a property tax regime that mitigates community risk and makes recessions shallower," or as "procyclical" when a property tax regime worsens community risk and deepens recessions.[53] It's been observed that "falling property values do not immediately reduce property tax revenue if the fall in value was preceded by several years of growth."[54] This leads to a procyclical tax that can run contrary to current economic circumstances, but can ensure more steady government revenues.[55]

However, the housing boom of the late 1990s and 2000s, and the subsequent Great Recession challenge this narrative. During this boom, municipal revenue growth grew faster than the economy as a whole.[56] Thus, there was "relative stability of the property tax as a source of central city revenue during the eleven years between 1997 and 2008."[57] When the recession and housing market crash occurred, the average municipality's property tax revenue fell by 7.8% while housing prices fell by 11.3%.[58] This revenue decrease was larger than the revenue decreases that resulted from state-level budget cuts.[59] However, many cities could more easily adjust property taxes; the result is that the share of local tax collections coming from property taxes increased from

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51. *See* Tracy Gordon, *Critics Argue The Property Tax Is Unfair. Do They Have A Point?*, TAX POL'Y CTR. (Mar. 9, 2020), https://www.taxpolicycenter.org/taxvox/critics-argue-property-tax-unfair-do-they-have-point.
52. John L. Mikesell & Cheol Liu, *Property Tax Stability: A Tax System Model Of Base And Revenue Dynamics Through The Great Recession And Beyond*, 13 PUB. FIN. & MGMT. 310, 314 (2013).
53. Andrew T. Hayashi, *Countercyclical Property Taxes*, 40 VA. TAX REV. 1, 5–6 (2020).
54. Andrew Hayashi & Ariel Jurow Kleiman, *Property Taxes During the Pandemic*, 96 TAXNOTES STATE 1461, 1462 (2020).
55. *Id.*
56. Howard Chernick et al., *The Impact of the Great Recession and the Housing Crisis on the Financing of America's Largest Cities*, 41 REG. SCI. AND URB. ECON. 372, 376 (2011).
57. *Id.* at 380.
58. *Id.* at 378.
59. *Id.* at 379.

75.5% to 80.3% between 2007 and 2011 in spite of collapsing real estate values.[60]

The short-term impacts of a recession on property taxes are limited. Research indicates a "three year lag between housing price changes and tax revenue [because] of assessment practices that only slowly brought assessed values into line with market values and of various caps and limitations built into the taxing process."[61]

Throughout the most recent pandemic-induced recession, property taxes remained a steady source of revenue because real estate values were resilient, and in fact increased, in spite of a recession in the broader economy.[62] This has caused local tax collections, which are disproportionately through property taxes, to rise, while state tax collections, which are more heavily income and sales tax, have decreased.[63] This further demonstrates the stability of property tax revenue. However, this inflexibility does have real downsides which I will discuss later in this Paper.

D. Property taxes are better than the alternatives.

Most municipal governments cannot either logistically or legally implement an income tax on their own.[64] That leaves only a few viable alternatives to property taxes to raise revenue for local government. One such option is implementing a local sales tax. However, sales taxes are typically considered regressive[65] and can lead to a reduction in consumer spending, which impedes economic

60. John Mikesell & Cheol Liu, *Property Tax Stability: A Tax System Model Of Base And Revenue Dynamics Through The Great Recession And Beyond*, 13 PUB. FIN. AND MGMT. 310, 312 (2013).

61. *Id.* at 315.

62. Charles S. Gascon & Jacob Haas, *The Impact of COVID-19 on the Residential Real Estate Market*, FED. RSRV. BANK OF ST. LOUIS (Oct. 6, 2020), https://www.stlouisfed.org/publications/regional-economist/fourth-quarter-2020/impact-covid-residential-real-estate-market.

63. Jared Walczak, *State Tax Collections Down 4.4 Percent Through September, While Local Tax Collections Rise*, TAX FOUND.: TAX POL'Y BLOG (Dec. 17, 2020), https://taxfoundation.org/state-tax-revenue-state-tax-collections-2020/.

64. Jared Walczak et al., *Local Income Taxes: A Primer*, TAX FOUND. (Feb. 23, 2023), https://taxfoundation.org/local-income-taxes-2023/.

65. TAX POL'Y CTR. BRIEFING BOOK, *Who Bears the Burden of a National Retail Sales Tax?,* (May 2020), https://www.taxpolicycenter.org/briefing-book/who-bears-burden-national-retail-sales-tax#:~:text=Because%20lower%2Dincome%20households%20spend,sharply%20as%20household%20income%20rises.

growth.[66] Another alternative is increasing "fines, fees and charges, which raise less revenue and often disparately impact vulnerable populations."[67] Therefore, even those who are concerned about tax regressivity and want a more progressive tax system might find property taxes the most palatable available option for local government taxation.

IV. DEFINING PROGRESSIVE TAX, REGRESSIVE TAX, & WEALTH TAX

A key component of the thesis of this Paper is that property taxes are both a regressive tax and a wealth tax. In order to demonstrate the truth of this statement, it is important to define the terms progressive tax, regressive tax, and wealth tax. While property taxes are not a pure wealth tax, it is a concept worth considering. The more pressing issue is whether property taxes are a progressive tax or regressive tax.

A "progressive tax" is a tax where "the average tax burden increases with income. High-income families pay a disproportionate share of the tax burden, while low- and middle-income taxpayers shoulder a relatively small tax burden."[68] An example of a "progressive tax" regime would be our U.S. federal income tax system (at least in the simplest of conceptions), where those who earn more money pay a higher marginal tax rate.[69] In the United States, the result of a progressive tax system is that the top 1% of income earners earned 22.2%of the national income, yet paid 42.3% of federal income taxes, in 2020.[70] Meanwhile, the lowest 50% of income earners, who earn about ten percent of the national income, pay approximately 2% of all federal income taxes.[71]

66. Andrew Hayashi & Ariel Jurow Kleiman, *Local Governments Need More Revenue. Try Progressive Property Taxes.*, THE WASHINGTON POST (May 7, 2020), https://www.washingtonpost.com/opinions/2020/03/20/coronavirus-is-upending-society-here-are-ideas-mitigate-its-impact/?arc404=true#Hayashi-Kleiman.

67. *Id.*

68. *Progressive Tax*, TAX FOUND., https://taxfoundation.org/tax-basics/progressive-tax/ (last visited Mar. 27, 2023).

69. *Id.*

70. Erica York, *Summary of the Latest Federal Income Tax Data, 2023 Update*, TAX FOUND. (Jan. 26, 2023), https://taxfoundation.org/publications/latest-federal-income-tax-data/.

71. *Id.*

The opposite of a "progressive tax" is a "regressive tax." Under a regressive tax, "the average tax burden decreases with income. Low-income taxpayers pay a disproportionate share of the tax burden, while middle- and high-income taxpayers shoulder a relatively small tax burden."[72] Regressive taxes can take a few different forms. Regressive taxes are often implemented at a flat tax rate, but become regressive because "lower-income individual[s] may face a higher tax burden than a higher-income individual with the same amount of consumption."[73] Since consumption taxes like sales and excise taxes tend to be at flat rates, they are two of the most common regressive taxes.[74] While less common, it could also theoretically take the form of marginal tax rates that decrease the higher the level of income is.[75]

A wealth tax is a tax "imposed on an individual's net wealth, or the market value of their total owned assets minus liabilities. A wealth tax can be narrowly or widely defined, and depending on the definition of wealth, the base for a wealth tax can vary."[76] While property taxes are imposed based on the valuation of an asset, a wealth tax is imposed on the gross value of that asset and does not take into consideration any liabilities connected to that asset. Since 62.9% of homeowners have a mortgage, a liability directly connected to the asset property taxes are imposed on, it would not meet this traditional definition of a wealth tax for most homeowners.[77] However, for a significant portion of homeowners (37.1%), property taxes come close to meeting this definition.[78]

V. PROPERTY TAXES ARE REGRESSIVE: THE CASE

While there is not a long-term consensus behind property taxes being regressive, there is a plethora of recent evidence to

72. *Regressive Tax,* TAX FOUND., https://taxfoundation.org/tax-basics/regressive-tax/ (last accessed July 22, 2023)
73. *Id.*
74. *Id.*
75. *Id.*
76. *Wealth Tax,* TAX FOUND., https://taxfoundation.org/tax-basics/wealth-tax/ (last accessed July 22, 2023).
77. Michael Neal, *Mortgage Debt Has Peaked. Why Has the Share of Homeowners with a Mortgage Fallen to a 13-Year Low?*, THE URBAN INST. (Aug. 20, 2019), https://www.urban.org/urban-wire/mortgage-debt-has-peaked-why-has-share-homeowners-mortgage-fallen-13-year-low.
78. *Id.*

make the case that they are.[79] Historically, property taxes were not considered regressive.[80] This was generally assumed under the "capital-tax view" which presumed that "local property taxes are largely shifted onto owners of capital throughout the economy," thus making them progressive.[81] These views were typically based upon the statutory incidence of property taxes rather than economic incidence.[82] Even decades ago, the measure of their progressivity was rapidly decreasing.[83]

A. Property taxes do not achieve horizontal or vertical equity.

Horizontal equity is "[a] principle used to judge the fairness of taxes, which holds that taxpayers who have the same income should pay the same amount in taxes."[84] This principle is used to assess whether tax burdens are fairly distributed. "Because owners of high-priced properties pay a lower effective tax rate than owners of low-priced properties, the property tax, as typically administered, does not satisfy horizontal equity."[85]

Vertical equity means "imposing a proportionately smaller tax burden on lower-income households than on high-net-worth households."[86] Property taxes fail at this mission because subject to exemptions, which will be addressed later, real property tends to be taxed at a fixed, flat rate. Additionally, lower-income households tend to spend a higher percentage of their income on housing than high-net-worth households.[87] That means a higher percentage of their income goes towards property taxes.

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79. Wallace E. Oates & William A. Fischel, *Are Local Property Taxes Regressive, Progressive, or What?*, 69 NAT. TAX. J. 415 (2016).

80. *See* Daniel B. Suits, *Measurement of Tax Progressivity*, 67 AM. ECON. REV. 747 (1977).

81. Oates & Fischel, *supra* note 79.

82. *Id.* at 416.

83. Suits, *supra* note 80, at 750.

84. Joseph J. Cordes, *Horizontal equity,* THE URBAN INST. (Oct. 1, 1999), https://www.urban.org/sites/default/files/publication/71101/1000533-Horizontal-Equity.PDF.

85. Christopher Berry, *Reassessing the Property Tax*, THE UNIV. OF CHICAGO HARRIS SCH. OF PUB. POL'Y AND THE COLL., at 19, (Jan. 2021), https://cpb-us-w2.wpmucdn.com/voices.uchicago.edu/dist/6/2330/files/2019/04/Berry-Reassessing-the-Property-Tax-Jan21.pdf.

86. *Vertical Equity*, CORP. FIN. INST., (Feb. 2, 2023), https://corporatefinanceinstitute.com/resources/economics/vertical-equity/.

87. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2015, (Jun. 24, 2015), https://www.jchs.harvard.edu/sites/default/files/media/imp/jchs-sonhr-2015-full_0.pdf.

B. Property taxes are not a true wealth tax.

Many characterize property taxes as a wealth tax, and wealth taxes are typically progressive. However, property taxes are not a true wealth tax, and thus are not as progressive as a true wealth tax. Property owners pay property tax on the assessed value of their property rather than the amount of equity they have in their homes. To illustrate:

> Suppose your only asset is a house worth $200,000 — slightly more than the median U.S. home. If you pay typical property taxes of 1 percent, that's $2,000 each year in taxes. But if you've borrowed three-fourths of the money for the house, your net worth is only $50,000. So that $2,000 property tax bill amounts to 4 percent of your net worth. That's a 4 percent wealth tax.[88]

Many people thought Sen. Elizabeth Warren's 2% wealth tax proposal on assets over $50 million was radical, but the consensus was that it was progressive.[89] However, the average property tax rate is higher than that in a few states.[90] And unlike Sen. Warren's proposal which affects a small percentage of Americans, property taxes impact any American seeking housing. Additionally, wealthier homeowners likely have more equity in their homes, meaning that less wealthy homeowners likely pay a higher rate on their home equity.[91] While describing property taxes as a "regressive middle-class wealth tax" is not technically correct given the basis for the tax, it is not a truly facetious remark either and represents a core issue of the current property tax regime, at least for those who do not favor regressive taxes.[92]

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88. Arik Levinson, *America's Regressive Middle-Class Wealth Tax*, THE HILL (Nov. 20, 2019, 2:30 PM), https://thehill.com/opinion/finance/471313-americas-regressive-middle-class-wealth-tax.

89. *Id.*

90. Janelle Cammenga, *How High are Property Taxes in Your State?*, TAX FOUND. (Aug. 26, 2020), https://taxfoundation.org/how-high-are-property-taxes-in-your-state-2020/.

91. Alexandra Killewald & Brielle Bryan, *Does Your Home Make You Wealthy?*, THE RUSSELL SAGE FOUN. J. OF SOC. SCI., 2 JSTOR. 110, 110–120 (2016).

92. Levinson, *supra* note 88.

C. Property tax relief programs only benefit homeowners, and sometimes they are regressive beyond that.

Homeowners tend to have higher incomes than renters; in 2016, homeowning households had nearly double the household income of renting households.[93] Despite homeowners generally having this higher level of income, they in fact get tax breaks for being homeowners. All but three states offer homestead exemption and property tax credit programs that tend to reduce the tax-burden on owner-occupied housing.[94] "Homestead exemptions reduce the amount of *property value* subject to taxation, either by a fixed dollar amount or by a percentage of home value. Property tax credits, in contrast, directly reduce the homeowner's tax bill by a fixed dollar amount or certain percentage."[95] The designs and eligibility criteria for these programs differ by state. As of 2012, "59% of state programs provided flat dollar exemptions, 19% provided percentage exemptions, and the final fifth used property tax credits or other more complicated formulas to determine the amount of tax relief for each homeowner."[96]

Percentage exemptions/credits are regressive in practice. This is because "percentage exemptions favor owners with higher-valued homes: a 10% across-the-board reduction lowers property taxes by only $100 on the $100,000 home but $400 on the $400,000 home."[97] However, flat dollar exemptions are the most popular form of property tax relief.[98] This is likely because on its face, it might appear to make property taxes more progressive because "homeowners with lower-valued homes usually receive the largest tax cuts in percentage terms."[99] Additionally, many of these programs receive full or partial funding from state governments

93. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., AMERICA'S RENTAL HOUSING 2017, at 7–12, (2017), https://www.jchs.harvard.edu/sites/default/files/02_harvard_jchs_americas_rental_housing_2017.pdf.

94. Adam H. Langley, *How Do States Spell Relief?*, LINCOLN INST. OF LAND POL'Y, (Mar. 23, 2023, 2:39 PM), https://www.lincolninst.edu/publications/articles/how-do-states-spell-relief.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

which "can help mitigate disparities in property wealth across localities."[100]

Despite property tax relief programs having progressive components, the fact that they tend only to be available for owner-occupied housing coupled with the fact that homeowners tend to have a far higher household income means that in reality, these often well-intended programs only further the regressivity of the property tax.

D. Renters, who tend to be lower income, bear much of the incidence of property taxes without the benefits of homestead exemptions and other tax breaks for owner-occupants.

There is a bit of debate as to who bears the incidence of property taxes on a rental property. On the one hand, the property owner physically pays property tax bills in the United States. On the other hand, a landlord likely considers the expenses of operating a rental property, including property taxes, when determining how much rent to charge their tenant. Under that setup, a renter effectively pays for property taxes as part of their rent. However, economists frequently do analyze who bears the incidence of different forms of taxation, and property taxes are no different.

Renters often prefer property tax increases over increases to income or sales taxes in comparison to homeowners.[101] That is likely because it does not directly hit them as they do not pay the property tax bill directly. However, the traditional view is that renters still pay property taxes; the traditional view is that renters bear the burden of the tax on improvements while landlords bear the burden of the land tax.[102] On the contrary, what Heilburn characterizes as the "new view"[103] is the belief that landlords bear the burden of the property tax, because the savings/investment rate does not significantly change based on rate of return, and that a property tax simply lowers the rate of return on that investment.[104]

100. *Id.*
101. Eric J. Brunner et al., *Homeowners, Renters, and the Political Economy of Property Taxation*, 53 REG. SCI. AND URB. ECON. 38 (2015).
102. *See* James Heilburn, *Who Bears the Burden of the Property Tax?*, 35 ACAD. OF POL. SCI. 57, 58–60 (1983).
103. Since this article was written in 1983, it isn't a particularly new view.
104. Heilburn, *supra* note 102, at 61.

However, Martinez-Vazquez and Sjoquist concluded that landlords can shift property taxes to their tenants if their tenants are willing to pay for the local government services financed by those taxes.[105] A true answer to this question depends on assumptions about the elasticities of rental housing supply and demand.[106] However, theory and reality do differ. The *Orlando Sentinel* reported in 2015 that "[r]enters and vacation-home owners now shoulder a bigger share of Florida property taxes than homeowners and owners of commercial property."[107] That same report stated that landlords typically "don't disclose [property] taxes, and renters end up being clueless about how taxes impact their rents," but that one landlord said he "can either go broke or pass the [increased property] tax along to my renters," saying that taxes staying flat would have saved his tenants 10% that year.[108]

While the answer to this fundamental question varies, there is evidence that multi-family housing, which is typically rental housing, is taxed at a far higher rate than owner-occupied single-family homes.[109]

E. Assessments that serve as the basis of property taxes over-assess lower-valued properties.

There is a growing body of research that indicates that the property tax assessments on properties in lower-income neighborhoods are generally over-assessed when compared to market values (often disproportionately people of color).

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105. Jorge Martinez-Vazquez & David Sjoquist, *Property Tax Financing, Renting, and the Level of Local Expenditures*, 55 S. ECON. J. 424, 429 (1988).

106. Richard W. England, *Tax Incidence and Rental Housing: A Survey and Critique of Research*, 69 NAT. TAX J. 435, 456 (2016).

107. Mary Shanklin, *Property-tax burden shifts to renters, second-home owners*, ORLANDO SENT. (Nov. 11, 2015, 5:53 PM), https://www.orlandosentinel.com/business/os-florida-property-taxes-20151110-story.html.

108. *Id.*

109. Jack Goodman, *House, Apartments, and Property Tax Incidence*, 9 (Am. Real Est. and Urb. Econ. Ass'n. Working Paper No. W05-2, 2005).

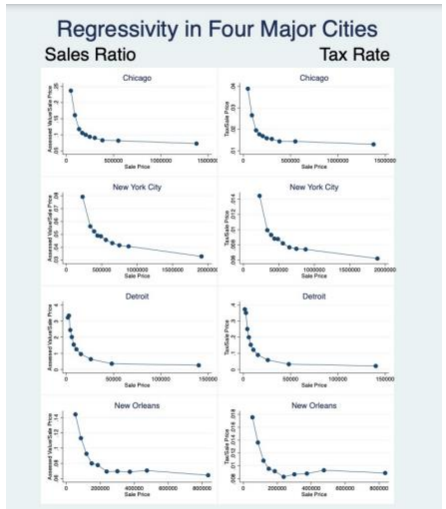

Figure 1: Regressivity in Chicago, Detroit, New Orleans, and New York

[110]

The chart above illustrates this issue in four major cities—Chicago, New York City, Detroit, and New Orleans. As for why this is the case, Berry offers a number of reasons. One reason is data and modeling limitations, because:

> Most statistical models used in assessment are based on some form of conditional averaging; that is, the assessed value for a particular property is based on the average value of other properties with the same observable characteristics. Depending on the jurisdiction, such conditional averaging may be implemented through a regression model or a comparables-based method (Gloudemans and Almy 2011; Officers 2018a). In either case, a property whose value is below average relative to its observable characteristics will be over-assessed, while a property whose price is high relative to its observable features will be under-assessed.[111]

Berry's analysis assumes that properties with similar "observable characteristics" should be similarly valued in the real estate market, which is something difficult to ascertain. Another reason is that "current assessments are based on sales from prior

110. *Reproduced from* Berry, *supra* note 85, at 26.
111. *Id.* at 4.

years and the interval between reassessments can be two to four years," if not longer.[112]

Alongside these procedural concerns, there are also explicit policy decisions that can fuel this trend. One of these policies is a cap on the annual increase of the taxable value of a property.[113] Since low-valued and high-valued homes often appreciate at different rates, this policy can in theory fuel regressivity or progressivity.[114] In situations where such a cap yields a lower tax burden, it is in theory regressive as it lowers the effective tax rate on a higher period asset. Specifically, such policies have been regressive in New York City but mildly progressive in Chicago.[115] While "assessment caps contribute to regressivity in some localities . . . caps do not have such impacts in general."[116]

Another specific concern is the classification of properties—whether it be a single-family home, condo, commercial, agricultural, industrial, or some other classification.[117] Sometimes, different classifications of properties are taxed at different rates, while other times, assessors and appraisers "use different statistical models for evaluating multi-family and single-family homes."[118] On a whole, "Duplexes and condominiums exhibit greater within-category regressivity than single-family homes" but differences between categories are not a driving force on average.[119] However, regressivity in the assessments for duplexes and condominiums is troubling since lower-end duplexes and condominiums likely attract lower-income individuals.

While Berry's overall findings on assessments are not particularly troubling, there are some incredibly problematic case studies. One of these case studies was in Cook County, Illinois, home to Chicago. While Illinois in theory has "a simple flat-rate property tax,"[120] the reality is far more confusing. John McCarron, a journalist with the *Chicago Tribune* and expert in property tax,

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112. *Id.* at 5. From personal experience, the wait for assessments can be much longer; my parents just got their first reassessment in nearly a decade in which home values in their area have generally decreased.

113. *Id.* at 3.

114. *Id.* at 5–6.

115. *Id.* at 15.

116. *Id.*

117. *Id.* at 16.

118. *Id.*

119. *Id.*

120. Daniel P. McMillen, *Assessment Regressivity*, THE LINCOLN INST. OF LAND POL'Y (Jan. 2011), https://www.lincolninst.edu/publications/articles/assessment-regressivity.

observed that "In all the topics I covered during my time at the Tribune, nothing was as confusing as property tax assessment."[121] McCarron's confusion is understandable as the "Cook County Assessor's Office (CCAO) has not been completely transparent with their practices."[122] The result of these practice is that "residents in working-class neighborhoods were more likely to receive property tax bills that assumed their homes were worth more than their true market value" while "many living in the county's wealthier and mostly white communities . . . caught a break because property taxes weren't based on the full value of their homes."[123] The result is that "people living in poorer areas tended to pay more in taxes as a percentage of their home's value than residents in more affluent communities."[124] Since people living in poorer areas also generally have a lower income than those in more affluent communities, this presumably means these people are also paying a higher percentage of their income towards their property taxes. These issues occur due to problematic modeling as well as "owners of high-priced homes are far more likely to appeal" their tax assessments.[125]

F. Property taxes run procyclical to the economy, meaning they worsen recessions.

As mentioned earlier, property taxes can be either "countercyclical," which means "a property tax regime that mitigates community risk and makes recessions shallower," or as "procyclical" when a property tax regime worsens community risk and deepens recessions.[126] However, they typically run procyclically because "falling property values do not immediately reduce property tax revenue if the fall in value was preceded by several years of growth."[127] This can prove disastrous to those who

121. Sahi Padmanabhan, *Regression: Cook County Property Tax Assessments Consistently Flawed,* FOURTEEN E. (Nov. 1, 2018), http://fourteeneastmag.com/index.php/2018/11/01/regression-cook-county-property-tax-assessments-consistently-flawed/.

122. *Id.*

123. Jason Grotto, *An Unfair Burden,* THE CHI. TRIB. (June 10, 2017), http://apps.chicagotribune.com/news/watchdog/cook-county-property-tax-divide/assessments.html.

124. *Id.*

125. *Id.*

126. Hayashi, *supra* note 53, at 6–7.

127. Hayashi & Kleiman, *supra* note 54, at 1462.

are detrimentally impacted by the recession.[128] During times of recession, it makes the most sense to allocate additional taxes on those experiencing the least amount of hardship.[129] Income taxes—being based on a current year's income—are good at doing just that.

G. The inflation of housing costs over time leads to a regressive tax on those with fixed income.

The rise of the cost of housing is a form of inflation. In the tax world, the incidence of inflation "is said to fall most heavily on persons with fixed incomes (for example, retired persons) and those who hold their savings in cash and cash-equivalents."[130] While this is sometimes addressed through homestead exemptions and caps on valued assets, it frequently is not. This is evidenced by Shan's finding among those over 50 that a $100 increase in annual property taxes is associated with a 0.73 percentage point increase in the 2-year mobility rate for homeowners over the age of 50, which is an 8%increase from the baseline 2-year mobility rate of 9%.[131]

VI. THE FEDERAL TAX SYSTEM FURTHERS REGRESSIVITY OF PROPERTY TAXES.

As a matter of law, Americans can currently deduct up to $10,000 per person (or $5,000 if filing as married filing separately) on their tax returns.[132] This includes property taxes. Ostensibly speaking, this deduction exists to (a) prevent double taxation and (b) encourage home ownership. Before the Tax Cuts and Jobs Act of 2017, this deduction was unlimited.[133] Since the enactment of the Tax Cuts and Jobs Act, there has been a political push spearheaded by Senate Majority Leader Chuck Schumer (D-NY) to restore the unlimited state and local tax deduction ("SALT

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128. Hayashi & Kleiman, *supra* note 66.

129. Hayashi, *supra* note 53, at 16.

130. *See generally* Allison Christians, *Introduction to Tax Policy Theory*, (May 29, 2018) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3186791).

131. Hui Shan, *Property Taxes and Elderly Mobility*, 67 J. OF URB. ECON. 194, 201 (2010).

132. *Topic No. 503 Deductible Taxes*, INTERNAL REVENUE SERV., (Mar. 3, 2023), https://www.irs.gov/taxtopics/tc503.

133. Erin Gobbler, *State and Local Tax (SALT) Deduction: What it is and How it Works*, BANKRATE (Nov. 8, 2019), https://www.bankrate.com/taxes/salt-tax-deduction/.

deduction").[134] Former House Speaker Nancy Pelosi (D-CA) and President Joe Biden are also on record as supporting the restoration of the unlimited SALT deduction.[135] At one point, nearly two dozen Democratic members of the House of Representatives vowed to support other taxes increases only if the unlimited SALT deduction is restored.[136] As it currently stands, the unlimited SALT deduction is set to return in 2026.[137]

The problem with the SALT deduction—and the reason it furthers the regressivity of property taxes—is that the vast majority of the benefits go to relatively high-income households, while lower and middle-income households either do not itemize their deductions or do not have a sufficient tax burden to maximize the deduction.[138] Even with the current cap on the SALT deduction, around three-quarters of the benefit goes to families in the top quintile of income distribution; 26% to the 95th-99th percentile; and over 12% to the top 1%.[139]

Restoring the unlimited SALT deduction would only make property taxes more regressive. According to research from the Tax Policy Center, almost all of the benefits (96%) from restoring the unlimited SALT deduction would go to the top quintile of earners, a majority would benefit the top one percent of earners (representing a tax cut of $33,100 to them), and twenty-five percent (25%) would benefit the top 0.1% (for an average tax cut of $145,000).[140] The benefit to the middle class is negligible; the remaining four percent of the benefit of removing the cap would go the middle class (i.e. middle 60%), for an average annual tax cut

134. Jordan Weissmann, *Democrats Should Keep Soaking New York and New Jersey on Taxes*, SLATE (Mar. 18, 2021, 2:01 PM), https://slate.com/business/2021/03/state-and-local-tax-deduction-salt-democrats-schumer.html.

135. Christopher Pulliam & Richard Reeves, *The SALT Tax Deduction is a Handout to the Rich. It Should be Eliminated, Not Expanded*, BROOKINGS, (Sep. 4, 2020), https://www.brookings.edu/blog/up-front/2020/09/04/the-salt-tax-deduction-is-a-handout-to-the-rich-it-should-be-eliminated-not-expanded/.

136. Laura Division & Laura Litman, *SALT'S Absence in Manchin, Schumer Talks Signals New Hurdles*, BLOOMBERG (July 13, 2022, 4:21 PM), https://www.bloomberg.com/news/articles/2022-07-13/salt-s-absence-in-manchin-schumer-talks-signals-problems-ahead?leadSource=uverify%20wall.

137. *Id.*

138. *Direct Federal Grants Are the Most Progressive and Effective Way to Fund Public Investments. Temporary Fiscal Relief*, ECON. POL'Y INST., (Dec. 18, 2019), https://www.epi.org/press/direct-federal-grants-to-state-and-local-governments-are-the-most-progressive-and-effective-way-to-fund-public-investments-temporary-fiscal-relief-can-also-help-states-fight-recessions/.

139. Pulliam & Reeves, *supra* note 135.

140. *Id.*

of a little less than $27.[141] To put some context on this level of regressivity, the SALT deduction is far more regressive than the whole of the 2017 Tax Cuts and Jobs Act—a piece of legislation that is frequently lambasted by those who want a more progressive tax code.

The sum of all this is that wealthier people, who already see a lower proportion of their income go towards property taxes, can in turn minimize their federal tax burden based on their property tax payments while poor, working, and middle-class people cannot do the same with their property tax payments. This is ultimately a question of federal tax policy, but federal lawmakers should consider the center-left Brookings Institution's conclusion that "At best, the SALT deduction is a warped way to do social policy; at worst it is a politically motivated handout to the richest people in the richest places. Either way, it is bad policy—especially at a time of rising inequality."[142] And while in theory conservatives are generally supportive of tax cuts, the conservative publication *The National Review* characterized the unlimited SALT deduction as a "tax bailout for rich liberals," because more liberal states and areas tend to have higher state and local taxes.[143]

Federal lawmakers might also want to consider the implications of the mortgage interest tax deduction—which is problematic for similar reasons to property taxes. By allowing those who itemize their deductions to deduct their mortgage interest, the mortgage interest tax deduction provides "unwarranted subsidies for the purchase of expensive homes by high-income taxpayers but does little to promote homeownership by those of more modest means."[144] Ultimately, it too is a regressive policy choice that benefits high-income homeowners while providing no benefit to owners of modest homes and renters. However, as these are decisions of the federal tax system, they are not the topic of this paper.

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141. *Id.*
142. *Id.*
143. Brad Polumbo, *Chuck Schumer's Tax Bailout for Rich Liberals*, NAT'L REV. (Apr. 6, 2021, 6:30 AM), https://www.nationalreview.com/2021/04/chuck-schumers-tax-bailout-for-rich-liberals/.
144. Alan D. Viard, *Proposal 8: Replacing the Home Mortgage Interest Deduction*, BROOKINGS (June 2016), https://www.brookings.edu/wp-content/uploads/2016/06/THP_15WaysFedBudget_Prop8.pdf.

VII. THE LEGALITY OF REGRESSIVE PROPERTY TAXATION

The Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution states that states shall not "deny to any person within its jurisdiction the equal protection of the laws."[145] Despite that text, courts have found the Equal Protection Clause to "not forbid classifications. It simply keeps governmental decisionmakers from treating differently persons who are in all relevant respects alike."[146]

In the case of *Nordlinger v. Hahn*, the U.S. Supreme Court considered whether California's property tax system, which capped the permissible increases of both property tax rates and assessed values and allowed people over 55 and children who inherited homes from their parents to avoid reassessment, violated the Equal Protection Clause.[147] The Court found that this difference in treatment between newer and older owners was constitutional because it "rationally furthers a legitimate state interest."[148] The Court supported this conclusion by noting that both newer and older homeowners benefit from this policy, and that the only different treatment was "the basis on which the[] property is initially assessed."[149]

However, this was not a unanimous decision. In his dissent, Justice Stevens noted that "some homeowners pay 17 times as much in taxes as their neighbors with comparable property.[150] For vacant land, the disparities may be as great as 500 to 1."[151] While the legislative history may have supported there being a legitimate state interest in the passage of this policy, I have difficulty conceptualizing the state interest in that reality. As Justice Stevens noted, "the rationale for such disparity is not merely 'negligible,' it is nonexistent. Such a law establishes a privilege of a medieval character: Two families with equal needs and equal resources are treated differently solely because of their different

145. U.S. CONST. amend. XIV.
146. Nordlinger v. Hahn, 505 U.S. 1, 10 (1992).
147. *Id.* at 3.
148. *Id.* at 11.
149. *Id.* at 12.
150. *Id.* at 76–77.
151. *Id.* at 29.

heritage."[152] While not binding law, past dissents can often form the foundation of future rulings.[153]

In deciding *Nordlinger*, the Supreme Court notably did not overturn *Allegheny Pittsburgh Coal Co. v. County Commissioner*. In that case, the Court held that "the fairness of one's allocable share of the total property tax burden can only be meaningfully evaluated by comparison with the share of others similarly situated relative to their property holdings."[154] That led to the Court concluding that the "relative undervaluation of comparable property . . . denies petitioners the equal protection of the law."[155] However, that ruling did "not prevent the State of California from classifying properties on the basis of their value at acquisition" in *Nordlinger*, "so long as the classification is supported by a rational basis."[156]

In addition, "most state constitutions require 'uniformity' or 'proportionality' in tax rates applied to property within a given class."[157] By the time of the Civil War, sixteen states placed "uniformity clauses" regarding property taxes in their state constitutions.[158] The theory behind "uniformity clauses" is "[prohibiting] using the property tax to favor or penalize the owners of particular kinds of property by setting particularistic schedules of tax rates."[159]

While inequalities of local tax rates within a state are certainly legal, some of the end products are not. For example, disparities in school funding caused by different property tax rates and bases have been found to violate the Equal Protection Clause of the U.S. Constitution.[160] Property taxes remain constitutional, but there are legitimate interpretations of both how the implementation and effects of property taxes could violate the key

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152. *Id.* at 30.

153. *See generally* Warren Richey, *Dissenting Opinions as a Window on Future Rulings*, THE CHRISTIAN SCI. MONITOR (July 1, 2002), https://www.csmonitor.com/2002/0701/p01s02-usju.html. While this certainly is a phenomenon, this author does not see the current Supreme Court changing course on this issue anytime soon.

154. Allegheny Pittsburgh Coal Co. v. Cnty. Comm'n, 488 U.S. 336, 346 (1989).

155. *Id.*

156. Nordlinger v. Hahn, 505 U.S. 1, 23 (1992).

157. Berry, *supra* note 85, at 20.

158. Robin L. Einhorn, *Species of Property: The American Property-Tax Uniformity Clauses Reconsidered*, 61 J. ECON. HIST. 974, 979 (2001).

159. *Id.* at 974.

160. *See* Van Dusartz v. Hatfield, 334 F. Supp. 870, 876 (D. Minn. 1971). This will be discussed in more detail later in Section IX.

facets of our Constitution and its concepts of fairness and equal protection.

VIII. CUTTING EDGE SOLUTIONS ATTEMPTING TO ADDRESS REGRESSIVITY.

While property taxes are still the predominant form of local taxation in the United States, there is a growing recognition that there are issues when it comes to affordable housing.

In Florida, a bipartisan group of legislators have introduced legislation permitting counties and municipalities to "to adopt ordinances to grant ad valorem tax exemptions to property owners whose properties are used for affordable housing."[161] If enacted, this legislation would help to address the regressivity of property taxes when it comes to lower-valued rental properties. However, when recently talking to one of the sponsors of this legislation (Rep. Ben Diamond of St. Petersburg), it seems like this legislation is not advancing this year.

Additionally, Hayashi and Kleiman have proposed transitioning to an explicitly progressive property tax system.[162] They characterize a progressive property tax as a "tax [that] could feature rates that increase with property values, income-based tax relief or deferral of payment" for groups such as senior citizens, the disabled, and the unemployed.[163] Notably, deferral of payment for specified groups is fairly akin to some already existing exemptions. However, Hayaski and Kleiman note that many of these reforms face "legal and political barriers," to which they urge "[s]tate legislatures [to] move quickly to delegate more tax authority to localities."[164]

IX. ALTERNATIVES TO PROPERTY TAXES AT THE LOCAL LEVEL.

One alternative to property taxes that is used by some local governments already are sales taxes. However, because sales taxes are considered regressive as low-income households consume a

161. H.B. 563, 2021 Leg., Reg. Sess. (Fla. 2021).
162. Hayashi & Kleiman, *supra* note 54.
163. *Id.*
164. *Id.*

higher proportion of their income than high-income households, it would encounter many of the same issues as property taxes.[165]

Income taxes are another alternative for local governments used widely in some states, but prohibited in others.[166] Raising the income tax would likely be progressive, as income taxes tend to collect a higher percentage of the income of higher-income individuals.[167] Where local income taxes exist, they are typically collected by state taxation agencies. Local income taxes exist in seventeen (17) states (as of 2019), but generally comprise a small amount of local revenue.[168] Rates are set by a mix of municipal, county, and special taxing districts like school boards.[169] However, even in states that have local income taxes, not all governments take advantage of this revenue source.[170] In the states that already have this system of local income taxation, it would be easy enough from a logistical standpoint to increasingly rely on these income taxes as a source of revenue. However, in states that do not have this existing tax infrastructure, it would be starting from scratch.

An alternative to having local governments set their own income tax rates would be for the federal and state governments to directly fund local governments/special taxing districts, and then raise that revenue through their existing income tax infrastructure. This model would be a massive shift on how local governments are funded and operated and would interfere with the Tiebout Model and the ability to "vote with your feet." Specifically, it would likely inhibit affluent communities from doing things like funding their public school districts more than less affluent communities. However, in some states, inequalities in areas like school funding are already limited. In *Van Dusartz v. Hatfield*, a federal court in Minnesota held that children in public schools had the right, under the Equal Protection Clause of the Fourteenth Amendment, for the level of spending for their education to be unaffected by the taxable wealth of their school district, or their

165. Hayashi, *supra* note 53, at 19.

166. Local income taxes are generally collected by state taxation agencies. Some cities set it separately, and some states have widespread local income taxation with each county having its own rate. Other states, like Florida, have a state constitutional prohibition on income taxes. *See* Jared Walczak, *Local Income Taxes in 2019*, TAX FOUND. (July 30, 2019), https://taxfoundation.org/local-income-taxes-2019/.

167. Hayashi, *supra* note 53, at 17.

168. Walczak, *supra* note 166.

169. *Id.*

170. *Id.*

parents.[171] Surprisingly, this case has not been widely replicated.[172] However, for those who believe the role of government is to build a more equitable society, this might be a strong path forward.

A non-tax alternative to property taxes would be to permit local governments to finance short-term deficits.[173] Such a move would enable governments to maintain services at a sufficient level during economic downturns. This would be important if local governments switched from property taxes to less stable forms of taxation. However, those more hawkish towards debt would likely cringe at the idea of encouraging the government to take on more of it.

X. CONCLUSION

While there is not a consensus among economists that property taxes are regressive, there are a number of red flags that indicate that property taxes are not the most progressive tax, and that they have many issues that could in fact make them regressive and discriminatory. Unfortunately, many local governments don't have an immediate source of revenue besides property taxes due to legal and practical obstacles. If local governments want to look towards fairer, more progressive forms of taxation, they may want to consider solutions such as Hayashi and Kleiman's "progressive property tax" or relying more upon income taxes. Unfortunately, solutions such as increased sales taxes or higher fines and fees do not address the issue of regressivity. Addressing these issues with property taxes could lead to a more equitable and fairer tax system for all.

171. Van Dusartz v. Hatfield, 334 F. Supp. 870, 877 (D. Minn. 1971).

172. *See* Battle v. Cherry, 339 F. Supp. 186, 194 (N.D. Ga. 1972); Baker v. Strode, 348 F. Supp. 1257 (W.D. Ky. 1971). While these courts did not adopt the holding in Van Dusartz, they also did not dismiss the findings of that court and no criticism of the Van Dusartz decision has been made by any circuit court of appeals or the U.S. Supreme Court.

173. Hayashi, *supra* note 53, at 15.

TAX CONSIDERATIONS AND CONSEQUENCES OF SECTION 338(H)(10) AND SECTION 336(E) ELECTIONS IN THE SALE OF S CORPORATIONS

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INTRODUCTION

Striking a balance between the tax concerns of purchasers and sellers during a business acquisition can involve intricate negotiations. Purchasers typically prefer an asset acquisition to steer clear of taking on undisclosed liabilities and to recoup costs through depreciation. On the other hand, sellers often favor a stock sale to completely divest from all facets of a business and to attain advantageous tax rates on capital gains. Nonetheless, in most circumstances, a stock acquisition remains the most expedient transaction structure from a business perspective.

When an acquisition involves a corporation as the target entity, the natural tension between purchasers and sellers is partly alleviated by the elections available under Section 338(h)(10) and Section 336(e) of the Internal Revenue Code of 1986, as amended ("I.R.C."), and the applicable treasury regulations promulgated thereunder ("Treas. Reg." or "Regulations"). Both provisions allow taxpayers to elect to treat certain sales, exchanges, or distributions of certain domestic corporations as a deemed sale of that corporation's assets for tax purposes.

Because S corporations are the most popular type of business entity, the availability of the deemed asset acquisition structure pursuant to the Section 338(h)(10) and Section 336(e) elections makes the S corporation a valuable and advantageous target entity in the world of mergers and acquisitions. If a deemed asset acquisition structure benefits the potential purchaser from a tax perspective, the pass-through taxation of the S corporation, which avoids double taxation, makes the shareholders of an S corporation target more likely to agree to structure the acquisition as a stock sale with either a Section 338(h)(10) or Section 336(e) election.

This Article focuses on the interaction of Section 338(h)(10) and Section 336(e) and the most common tax and other business issues considered by purchasers and sellers when an acquisition transaction involves an S corporation target. Part I of this Article outlines the qualifications, limitations, and taxation of S corporations. Part II explores various considerations of the parties involved in a transaction when determining acquisition structure, including the general preference of sellers for stock sales and purchasers for asset acquisitions, as well as the benefits of having an S corporation as the target entity in comparison to a C corporation. Part III details the requirements for making an election under Section 338(h)(10) and Section 336(e), as well as the intersection of these two available elections with respect to the purchase and sale of S corporations. Part IV of this Article identifies various considerations involved in deciding whether to structure a transaction as an asset or stock acquisition, including whether to consider making a Section 338(h)(10) or Section 336(e) election, such as the qualification of the target entity as an S corporation, the tax basis of the target corporation, and the character of the gain or loss from the sale. Part V discusses the tax treatment and consequences of a Section 338(h)(10) and Section 336(e) election at various stages of the transaction and from the perspective of each party involved. Part VI highlights some of the proposed changes to the U.S tax code and the resulting effects on the popularity of the S corporation target in future business acquisition transactions. Finally, Part VII concludes that the S corporation is a preferable and beneficial target entity—particularly in a stock sale structured as a deemed asset acquisition using a Section 338(h)(10) or Section 336(e) election. Even considering potential tax rate increases under the U.S tax code, the availability of the Section 338(h)(10) and Section 336(e) elections will remain a valuable tax planning tool for potential purchasers in corporate acquisition transactions.

I. QUALIFICATION AS AN S CORPORATION

A. S Corporations

"[T]he term 'S corporation' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year."[1] Per Section 1361(b)(1), the term "small business corporation" means an eligible domestic corporation, having no more than 100 shareholders, which shareholders are only individuals[2] who are either resident aliens or citizens of the United States, and which only has one class of stock.[3]

1. I.R.C. § 1361(a)(1).

2. The requirement that shareholders be individuals is subject to exceptions for an estate, a trust described in I.R.C. § 1361(c)(2), or an organization described in I.R.C. § 1361(c)(6). *See* I.R.C. § 1361(b)(1).

3. I.R.C. § 1361(b)(1). An eligible corporation is any corporation which is not deemed to be ineligible per I.R.C. § 1331(b)(2) (ineligible corporation means any corporation that is

B. Availability of and Limitations to an S Corporation Election

To be treated as an S corporation for tax purposes, an eligible corporation must affirmatively make an effective election under Section 1362.[4] The election is made by the corporation and there are several technical requirements that must be met to make a valid election, including the consent to such an election by all persons who are shareholders in such corporation on the day on which such election is made.[5] An S corporation election is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated under I.R.C. Section 1362(d).[6]

C. Taxation of S Corporations

Unlike C corporations, S corporations are normally not subject to taxation at the entity level; rather, an S corporation is generally taxed in the same manner as an individual. Profits and losses of an S corporation generally pass-through to its shareholders, and such shareholders include their respective share of those items on their U.S. federal income tax returns. This avoids double taxation of the S corporation's corporate income.

II. CONSIDERATIONS REGARDING CHOICE OF ACQUISITION STRUCTURE

Purchasers and sellers are often at odds over whether a transaction should be structured as a purchase of assets or a purchase of stock of the target corporation. The acquisition structure selection can greatly alter the tax consequences of the transaction for the parties, with sellers typically deriving the most favorable tax consequences from a stock sale and purchasers typically deriving the most favorable tax consequences from an asset acquisition. Thus, seller and purchaser have diverging interests from the very initial stages of negotiation. Generalities

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a financial institutional using the reserve method of accounting for bad debts described in Section 585, an insurance company subject to tax under subchapter L, or a domestic international sales corporation ("DISC") or former DISC).

4. I.R.C. § 1362(a)(1)–(2).
5. *Id.*
6. I.R.C. § 1362(c).

aside, there are multiple tax and other factors that seller and purchaser must (or should) consider before agreeing on final acquisition structure, including, the target company entity type, the different types of relevant assets, the aggregate basis of the target entity's assets, the fair market value of such assets, the target shareholders' basis in their target shares, the character of potential gains and losses, the right to transfer or assign various assets, and purchase price calculations and determinations.

Each of these factors needs to be considered against the expectations of the parties, as well as the history, operations, and other information relevant to the target entity. Although tax consequences are not always the primary factor driving acquisition structuring, having an S corporation as the target entity improves the possibility of the parties coming to a swift consensus on a transaction structure that is mutually advantageous to the parties from both a taxation and legal perspective. Assuming all gain is characterized as long-term capital gain, the S corporation shareholders will be impartial for federal tax purposes as between an asset or stock sale. However, certain commercial and legal considerations can cause the purchaser and the S corporation sellers to prefer a stock acquisition. As explained in more detail below, the interests of the sellers and the purchaser of an S corporation target converge when applying the specific acquisition structure that is the topic of this Article—a stock sale treated like an asset sale for tax purposes using an election under I.R.C. Section 338(h)(10) or Section 336(e).

A. Preferences of C Corporation Seller and the Double Tax on Sale of Assets

Sellers generally prefer to structure a transaction as a sale of stock (rather than an asset sale) because a purchaser of stock acquires all assets and liabilities of the corporation, leaving sellers without any contingent liabilities with respect to the corporation post-closing.[7] The preference for stock sales is further strengthened by the fact that sellers typically receive better tax treatment when selling stock as opposed to assets of the

7. *See* William W. Potter, *Section 338(h)(10) Elections Section 338 (h)(10) Elections of S Corporations, Incremental Costs, and Considerations Following Tax Reform*, 45 WGL-CTAX 03, at *5 (Nov./Dec. 2018).

corporation.[8] In the case of a C corporation, its shareholders will generally prefer a traditional stock sale because it avoids the double taxation that is characteristic to C corporations. In a traditional asset sale, the C corporation shareholders are subject to two levels of taxation—the 21 percent flat tax applicable to C corporations and paid at the entity level on the sale of assets and a second level of tax at the shareholder level from the distribution of proceeds resulting from the asset sale. This double taxation regime on C corporations makes stock sales preferable for C corporation shareholders because the stock sale imposes only one level of taxation at the shareholder level, which is generally taxed at the preferential long-term capital gain tax rate.

Example 1: Suncoast Inc., a C corporation, sells its assets for cash consideration of $1,000,000. Assuming Suncoast Inc. has a zero-tax basis in the assets, Suncoast Inc. recognizes a gain of $1,000,000 from the asset sale. Suncoast Inc. is taxed on the $1,000,000 of gain at the corporate tax rate of 21 percent. After Suncoast Inc. pays the $210,000 in corporate-level taxes, there is $790,000 of cash remaining for a dividend to the shareholders. A $790,000 dividend paid to the shareholders will be subject to a second level of tax imposed on the shareholders of Suncoast Inc. Assuming the distribution is a qualified dividend, the highest income tax rate applicable would be 20 percent (or 23.8 percent if net investment income tax ("NIIT") is applicable).[9] Thus, the total tax to be paid by the shareholders on receipt of the distribution would be $158,000 (or $188,020 if NIIT applies), resulting in $632,000 net cash to the Suncoast Inc. shareholders (or $601,980 if NIIT applies).[10] The total tax on the distributed corporate income

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8. *See id.*

9. *See* KAREN C. BURKE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS IN A NUTSHELL 2 (8th ed. 2019). "Thus, under current law the maximum combined burden on distributed corporate earnings is 36.8%, or slightly less than the maximum individual rate (37%). The combined burden is actually somewhat higher because dividends are subject to the 3.8% tax on net investment income under § 1411, which is intended to mirror the Medicare tax on "earned income." For high-income individuals, the overall tax rate for qualifying dividends and long-term capital gain is 23.8% (20% plus 3.8%). As a result, the combined tax burden is 39.8% for such individuals." *Id.*

10. Jerald D. August, *Understanding the 199A Deduction After the New Final Regulations: An IRS Perspective*, Aug. 25, 2023, VCAG0416 ALI-CLE 1 (West). ("This should be contrasted to a top marginal tax rate of 37% on the income of a pass-through entity or sole proprietorship even if the taxpayer derives no benefit whatsoever from the deduction available under Section 199A, or a top marginal tax rate of 29.6% on the QBI of a pass-through entity or sole proprietorship where the taxpayer receives the full benefit of Section 199A without being subject to the wage and capital limitations.").

would be $368,000 ($210,000 plus $158,000) (or $398,020 considering NIIT ($210,000 plus $188,0200)). Overall, the maximum combined effective double-tax rate for Suncoast Inc. is 36.8 percent ($368,000 divided by $1,000,000 income) (or 39.8 percent with NIIT).

B. Preferences of S Corporation Seller

In the case of an S corporation, there is generally no taxation at the entity level but rather there is only a single level of taxation imposed on corporate income—at the shareholder level.[11] In the case of either an asset sale or a stock sale, S corporation shareholders are subject to only one level of tax.[12] Thus, a stock sale of an S corporation results in the same general federal tax consequences as the stock sale of a C corporation. However, an asset sale in an S corporation results in vastly different tax results as compared to an asset sale in a C corporation. The gain from the sale of assets in an S corporation avoids the entity level tax and instead such gain is passed through to the shareholders, to be taxed on the shareholders' tax returns.[13] With the exception of gains associated with a sale or other disposition of certain items that are taxable as ordinary income, such as inventory, depreciation recapture, and other ordinary income items,[14] "the gain passed out to the S corporation shareholder is taxed as a capital gain to the individual."[15] Following the asset sale in an S corporation, a "subsequent liquidating distribution, unlike the case of a Subchapter C–Corporation, escapes taxation as a return of capital."[16] Thus, with S corporation asset sales, the selling shareholders are taxed a single level of tax at the maximum capital gains rate of 20 percent,[17] resulting in a lower tax burden and more cash on an after-tax basis as compared to C corporation asset sales. Consider the following example:

11. *New Tax Structuring Tool in the Acquisition of S-Corporations*, WINDES (Sept. 26, 2017), https://windes.com/tax_alerts/new-tax-structuring-tool-acquisition-s-corporations/.
12. *Id.*
13. *See* Samuel T. Greenberg & Andrew T. Davis, *Acquisition Structures*, 74 N.Y.U. ANN. INST. FED. TAX'N § 4.03(6)(c)(ii) (2021).
14. *See id.* § 4.03(3)(a).
15. WINDES, *supra* note 11.
16. *Id.* This is unlike the case of a Subchapter C corporation, which imposes the second layer of shareholder tax on subsequent liquidating distributions.
17. *Id.*

Example 2: RIZ Inc., an S corporation, sells its assets for cash consideration of $1,000,000. Assuming RIZ Inc. has a zero-tax basis in the assets, RIZ Inc. recognizes income of $1,000,000 from the asset sale. RIZ Inc. has a basis of $1,000,000 in the cash received. The $1,000,000 of income retains its character as it "flows through" to RIZ Inc.'s shareholders, who report and are taxed on their pro rata share of such $1,000,000 of income (irrespective of RIZ Inc. paying actual distributions to such shareholders). So, assuming the assets sold were all long-term capital assets in the hands of RIZ Inc., the capital gain character is passed through to the $1,000,000 of income, which then flows through to the RIZ Inc. shareholders, who must each pay their pro rata share of tax on such income at the applicable capital gains rate.[18] At the maximum capital gains tax rate of 20 percent (or 23.8 percent if adding the 3.8 percent NIIT),[19] this, will result in $200,000 of taxes due (or $238,000 if taxed at 23.8 percent) in the aggregate from the RIZ Inc. shareholders. The $1,000,000 of income also increases the RIZ Inc. shareholders' basis in their RIZ Inc. shares by the same amount (respectively, by each shareholders' pro rata share of such income), bringing their collective basis to $1,000,000. A subsequent distribution by RIZ Inc. of the $1,000,000 of income to its shareholders will reduce the shareholders' collective basis in their RIZ Inc. shares by the amount of the distribution (with each shareholder's basis in her respective RIZ Inc. shares reduced by her pro rata share of such distribution received). Thus, absent any other transaction or character difference in the gain, when the $1,000,000 of income is distributed, no shareholder recognizes any

18. The character of income (or loss) earned by the S corporation (as determined at the corporate level) passes through to its shareholders and remains (and is taxed) the same in the shareholders' hands. I.R.C. § 1366(b). Accordingly, if the assets sold were instead RIZ Inc.'s inventory, the ordinary income character would pass through to the shareholders and be taxed at the *individual* rate applicable to each such shareholder, which is currently at a top rate of 37 percent (or 40.8 percent if adding 3.8 percent NIIT).

19. "This should be contrasted with the sale of assets by an S corporation, partnership or LLC taxed as partnership, or a sole proprietorship, where typically the bulk of the sales price is allocated to capital assets (such as goodwill), so that the maximum marginal rate to which the gain on the sale of the assets will be subject will either be 20% (the maximum capital gains tax), or, if the taxpayer does not materially participate in the trade or business carried on by the entity, 23.8% with the addition of the Net Investment Tax." August, *supra* note 10. NIIT applies to passive types of income, such as interest, dividends, capital gains, royalties, and rents, as well as pass-through income from a passive business like an S corporation. If the shareholder-taxpayer materially participates in the trade or business of the S corporation, the pass-through income is not treated as passive and is not subject to NIIT.

additional gain or loss because their respective pro rata share of such $1,000,000 distribution equals such shareholder's basis in her shares of RIZ Inc.[20] Thus, the RIZ Inc. shareholders end up with an aggregate net cash amount of $800,000 (or $762,000 if taxed at 23.8 percent).

C. Preferences of Purchaser

On the other hand, potential purchasers generally prefer to purchase the assets of a corporation for several reasons. From a tax perspective, a buyer who purchases assets of a business can receive a stepup in basis, which generates post-transaction tax benefits and increases cash flow through the use of amortization and other deductions.[21] In an asset sale, the purchaser takes a basis in the acquired assets equal to the fair market value at the time of transfer;[22] thus creating a "step-up" in basis if the transferors basis in the assets was less than the fair market value at the time of sale.[23] In light of the 2017 Tax Cuts and Jobs Act, an asset acquisition became even more favorable to a purchaser because it could immediately expense the cost of tangible personal property with a recovery period of 20 years or less.[24] This is otherwise known as bonus depreciation—available at a rate of 100 percent of the purchase price for assets acquired and placed into service after September 27, 2017, but before January 1, 2023, with sunsetting bonus depreciation percentages through 2026.[25] Another form of immediate expense deduction available to a purchaser acquiring depreciable business equipment (such as office equipment, business machinery, computers, vehicles, or software) is Section 179 expensing.[26] In essence, the purchaser's investment begins immediately paying for itself in the form of tax

20. *See* Potter, *supra* note 7, at *3. If the S corporation makes later distributions of its income, such distributions are generally tax free to the shareholders to the extent they reflect income that has already been taxed to the shareholders. I.R.C. § 1368.

21. *See* Potter, *supra* note 7, at *3.

22. I.R.C. § 1012.

23. There is a step-down in basis if the target company's basis in its assets exceeds its fair market value.

24. I.R.C. § 168(k).

25. *See infra* Section 0.0.1 (discussing bonus depreciation as an immediate expense deduction).

26. *See infra* Section 0.0.2 (discussing Section 179 expensing as an immediate expense deduction).

benefits.[27] In contrast, in a stock purchase, the purchaser takes a transferred basis in the target corporation's assets, which leaves the purchaser without amortizable intangible assets (such as goodwill), and generally, assuming the fair market value is greater than its basis and the value of assets continue to appreciate, the purchaser is subject to taxation on a greater amount of gain realized on a subsequent sale of the acquired assets in target corporation. Consider the following examples.

Example 3: Izabella, an individual, owns all the stock of RIZ Inc., an S Corporation. Her basis for the stock is $100,000. RIZ Inc. has only two assets, equipment and land. The equipment has a basis of $120,000 (with $150,000 depreciation) and a fair market value of $400,000, and the land has a basis of $180,000 and a fair market value of $600,000.

Example 3(a): Lekko Corporation, a C corporation, purchases all the assets of RIZ Inc. for cash consideration of $1,000,000. Lekko Corporation takes a cost basis in the acquired assets of $1,000,000. Under Section 1060, the purchase price is allocated among the acquired assets up to their fair market value. Thus, Lekko Corporation takes a cost basis of $400,000 in the equipment and $600,000 in the land. Although the land is not depreciable, Lekko Corporation will be able to immediately begin depreciating the equipment using the stepped-up basis of $400,000. Upon subsequent sale of the land for $750,000, Lekko Corporation uses the $600,000 basis and is subject to tax on $150,000 of gain.

Example 3(b): Lekko Corporation purchases all the stock of RIZ Inc. for cash consideration of $1,000,000. Lekko Corporation takes a cost basis in RIZ Inc. stock of $1,000,000. The RIZ Inc. stock is neither depreciable nor amortizable. Thus, Lekko Corporation simply retains the $1 million basis in the stock until Lekko Corporation eventually sells the shares, at which point the basis will be available to offset the sales proceeds. Lekko Corporation acquires the equipment and the land without taking it out of RIZ Inc., so the basis in the assets does not change. Thus, Lekko Corporation has a transferred basis of $120,000 in the equipment and $180,000 in the land. The basis in assets does not change because this was a stock sale. When stock is purchased, nothing changes inside the target. Thus, even though Lekko Corporation

27. Essentially, it is a return on purchaser's investment in the form of immediate tax deductions.

paid $1,000,000 for RIZ Inc., the basis RIZ Inc. held in its assets remains unchanged in the hands of Lekko Corporation. As a result, Lekko Corporation is left depreciating the equipment using the remaining $120,000 of tax basis. Upon subsequent sale of the land for $750,000, Lekko Corporation uses the $180,000 basis and is subject to tax on $570,000 of gain.

In comparing the tax results to Lekko Corporation, the purchaser, in the asset purchase in Example 3(a) versus the stock purchase in Example 3(b), it is evident that Lekko Corporation is not receiving the same results even though in both cases Lekko Corporation is paying the same amount to acquire all of RIZ Inc. In the asset sale, Lekko Corporation has the added tax benefit of an additional $160,000 in depreciation deductions in the equipment ($400,000 basis following the asset sale – $120,000 basis following a stock sale), and Lekko Corporation also has less taxable gain on a future sale of land ($150,000 taxable gain if the land were acquired in an asset sale as compared to $570,000 taxable gain in a stock sale). The purchaser, in this case Lekko Corporation, would likely discount the purchase price.

Should Lekko Corporation pay the same amount ($1,000,000) for the RIZ Inc. stock as it would for the assets of RIZ Inc.? If the equipment is worth $400,000 and the land is worth $600,000 and Lekko Corporation is taking a basis of $1,000,000 in the stock of RIZ Inc. (which is not depreciable), Lekko Corporation is not getting the same value for its money because following the stock purchase Lekko Corporation has assets with built-in gain. Whereas, in the asset purchase, the basis in the assets acquired is stepped-up to match the fair market value resulting in no built-in gain or loss to Lekko Corporation in the acquired assets. In a stock purchase, Lekko Corporation acquires the land with a built-in gain of $420,000 ($600,000 fair market value – $180,000 basis) and the equipment with a built-in gain of $280,000 ($400,000 fair market value – $120,000 basis). Lekko Corporation also cannot amortize the basis in the RIZ Inc. stock acquired. Based on such after-tax results, Lekko Corporation would definitely not pay the same amount in a stock acquisition as it may in an asset acquisition because the parties will take into account the after-tax consequences of the transaction when they are setting the purchase price. Here, the built-in tax liabilities of a stock acquisition of RIZ Inc. would prompt a lower purchase price. The purchaser, in this case Lekko Corporation, would discount the purchase price in a stock acquisition because it is not receiving a corresponding basis step-up.

If the purchase price in Example 3(b) was $800,000 (instead of $1,000,000), the $700,000 of income ($800,000 amount realized – $100,000 basis in stock) would be passed through to the RIZ Inc. shareholder, who is taxed on that $700,000 of income at the maximum individual capital gains tax rate of 20 percent, resulting in $140,000 taxes owed. RIZ Inc. shareholder has $560,000 cash after tax. In this scenario, Lekko Corporation takes a $800,000 cost basis in the stock. Lekko Corporation's basis in the equipment and land still does not change (stays at $120,000 and $180,000, respectively). But in this scenario, the purchase price better reflects the built-in tax onthe assets acquired, as well as the fact that Lekko Corporation is not able to amortize the purchase price of the RIZ Inc. stock.

This pursuit of the "stepped-up" tax basis (in addition to avoiding hidden liabilities) is a primary incentive driving purchasers' preference to pursue an asset acquisition rather than a stock acquisition.[28]

D. Other Acquisition Considerations

In addition to the tax consequence considerations, purchasers are further enticed to structure a transaction as an asset sale because an asset sale provides purchasers with the ability to select specific assets and liabilities of the target corporation that it actually wants to assume; thereby avoiding wasting money on unwanted assets, as well as any additional risk of assuming unknown or undisclosed liabilities.[29] Asset sales grant purchasers this type of flexibility, while stock sales, on the other hand, require the purchaser to assume all of the assets and liabilities of target corporation.[30]

Although purchasers may prefer to purchase the assets of an S corporation, certain non-tax factors may require the transaction to be structured otherwise. Due in part to the restrictive

28. Tony Nitti, *Tax Geek Tuesday: A Buyer's Best Friend – Understanding The Section 338(h)(10) Election*, FORBES (Oct. 5, 2015, 6:34 PM), https://www.forbes.com/sites/anthonynitti/2015/10/05/tax-geek-tuesday-a-buyers-best-friend-understanding-the-section-338h10-election/?sh=8edcc644fa0d.

29. James R. Hamill, *Purchases and Sales Involving S Corporations*, 92 TAXES 65 (2014).

30. *See* Potter, *supra* note 7, at *5.

qualification requirements of S corporations, the physical transfer of S corporation assets and contracts can become incredibly time-consuming, problematic, and in certain situations, even impossible, which in turn might cause the purchaser to have no choice other than acquiring the stock of the target corporation and thus potentially losing the tax step-up and other tax benefits afforded to purchasers in an asset acquisition.[31] For example, this can occur when the target has key contracts that are not freely transferable or assignable to purchaser. When this is the case, the only way to acquire the contracts might require target corporation to remain a party to such contracts, requiring the preservation of target corporation's separate legal existence so that the key contracts remain valid and effective.[32]

On the other hand, sellers of an S corporation will still generally prefer a stock sale as compared to an asset sale due to other non-tax considerations. Sellers generally prefer to structure an acquisition as a stock sale because in a stock sale, the purchaser assumes *all* liabilities of the target company as a matter of law.[33] As compared to an asset sale, in which case the sellers are left with known and unknown liabilities of the target company, which the purchaser does not expressly assume.[34] Asset acquisitions are generally also more complex and time consuming than stock acquisitions, which may involve "the retitling of assets and renegotiation of certain contracts and governmental permits."[35] As a result, it is common for parties to structure an acquisition of the target company as a stock sale with a Section 338(h)(10) election or a Section 336(e) election, which will allow for many of the tax benefits of an asset sale.[36]

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31. WINDES, *supra* note 11.
32. Nitti, *supra* note 9. Other situations that may require the transaction to be structured as a stock sale include state and federal regulatory restrictions, as well as required retention of target company's Employer Identification Number.
33. Potter, *supra* note 7, at *3.
34. Bryan F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN ST. L. REV. 913, 917 (2012).
35. Potter, *supra* note 7, at *4.
36. *Id.*

III. PURCHASE AND SALE OF S CORPORATIONS TRANSACTION STRUCTURE

In the case of S corporation target entities, many of the concerns relating to asset versus stock acquisition structure have been eliminated because of the Section 338(h)(10) election and the Section 336(e) election (hereinafter, the "Elections"). The Elections allow the parties to treat an acquisition transaction as a sale of assets for tax purposes, though, legally transferring the stock of the S corporation.[37] This allows the parties to proceed with the ease of transferability inherent in a stock sale, while still benefitting from the favorable tax consequences of an asset sale.

A. CHOICE OF ENTITY STATISTICS

Despite the popularity of LLCs in the last 20 years, the number of entities filing S corporation returns exceeds the number of entities filing partnership returns and it is projected to stay that way for the foreseeable future. S corporations continue to be the most prevalent type of corporation, making S corporations a prevailing target entity in the world of mergers and acquisitions, due to both number and advantage.[38] For Tax Year 2019, there were 5,186,557 returns filed by S corporations (filing a Form 1120-S), translating to approximately 70.7 percent of all corporations in the U.S. classified as S corporations.[39] As discussed in Part II, the pass-through taxation of S corporations, which avoids double taxation,[40] makes S corporations advantageous target entities for potential purchasers because S corporation shareholders are generally indifferent as to whether the purchaser wants to structure an acquisition as either an asset or a stock sale.

B. S Corporations and the Elections

When comparing a C corporation with a similarly situated S corporation, the S corporation will generally be a more appealing

37. WINDES, *supra* note 11.
38. Total of 7,333,461 returns filed by all corporations, of which 2,146,904 returns filed by C corporations or other corporations and 5,186,557 returns filed by S corporations, per form 1120-S. *See* SOI Tax Stats - IRS Data Book, *available at* https://www.irs.gov/pub/irs-pdf/p55b.pdf.
39. *Id.*
40. With the exception of built-in gain tax under I.R.C. § 1374.

target company from both a business and tax perspective because of the availability of the deemed asset acquisition elections under Section 336(e) and Section 338(h)(10) while avoiding the double taxation inherent in C corporations. In a deemed asset acquisition, the S corporation stock is "sold without the complexity of disposing of individual assets, but with the tax advantage of a step-up in the [S] corporation's asset basis for the purchaser."[41] To achieve this desired stepped-up basis, a Section 338(h)(10) election or a Section 336(e) election must be made.[42]

C. Section 338(h)(10) Election

A Section 338(h)(10) election is available only in limited situations. To be eligible to make the Section 338(h)(10) election, the parties involved in the transaction must meet specific statutory and regulatory requirements. If a valid Section 338(h)(10) election is made, even though the purchaser acquired the target company's stock, for tax purposes only, the transaction is treated as if the purchaser acquired only the target company's assets.[43]

The availability of a Section 338(h)(10) election is restricted to only the types of entities and organization structures specifically identified in the Regulations.[44] Generally, a Section 338(h)(10) election may be made when one *corporation* purchases the stock of another *corporation*.[45] In other words, the Section 338(h)(10) election can only be made if both the purchaser and the target are corporations, whether a C corporation or an S corporation. Thus, if either the purchaser or target is a partnership, an LLC not treated as an S corporation for tax purposes, or any type of entity other than a corporation, the Section 338(h)(10) election is unavailable.

41. Horacio et al., *Section 336(e) Deemed Asset Acquisitions and S Corporations*, DAILY BLOOMBERG BNA - TAX REPORT (March 31, 2014).

42. Jerald D. August & Stephen R. Looney, *Tax Planning for S Corporations: Mergers and Acquisitions Involving S Corporations (Part 1)*, 30 Prac. Tax Law. 19, 37 (Winter 2016)[hereinafter Looney]. The transaction can also be structured as an F reorganization/Qsub deemed sale of assets. Jerald D. August & Stephen R. Looney, *Tax Planning for S Corporations: Mergers and Acquisitions Involving S Corporations (Part 3)*, 30 Prac. Tax Law. 42, 53 (Summer 2016).

43. The purchaser can also make an election under I.R.C. Section 338(g) (a Section 338(g) election) but this election is less common because it often results in adverse tax consequences for the seller.

44. Nitti, *supra* note 28; *see* Treas. Reg. §§ 1.338–2, 1.338–2, 1.338(h)(10)–1.

45. *See* I.R.C. §§ 338(d)(1)–(2), 338(h)(2)(d)(1), (2) (identifying and defining purchasing corporation and target corporation as only a "corporation").

This also means that the Section 338(h)(10) election is unavailable to purchasers who are individuals.[46] Further, the purchaser can only be a single corporation, which means that there cannot be more than one purchaser of the target entity in the transaction.[47]

To qualify for the Section 338(h)(10) election, the seller of the target company must be one of the following:[48] (1) a domestic subsidiary corporation in the same consolidated group as the target company, and which group meets the Section 1504 control requirement ("selling consolidated group");[49] (2) a domestic subsidiary corporation that has Section 1504 control of a domestic target company and that is *eligible* to file a consolidated return with target, but chooses not to ("selling affiliate");[50] or (3) one or more S corporation shareholders.[51]

Per Section 1504, a selling consolidated group or selling affiliate must be part of a chain of corporations connected through ownership by at least 80 percent of total voting stock and 80 percent of total value of stock owned by the common parent corporation and at least one other corporation in the group.[52]

Example 4(a): Consider the same facts as in Example 3 and Example 3(b), with the parties desiring to make a Section 338(h)(10) election. Because RIZ Inc. is an S corporation, Izabella meets the definition of a seller under Reg. Section 1.338(h)(10)–1(c) as an S corporation shareholder. Lekko Corporation is a C corporation, which satisfies the corporate purchaser requirement under Section 338. Thus, the Section 338(h)(10) election is available to Lekko Corporation and Izabella in a qualified stock purchase of RIZ Inc.

Example 4(b): Vanessa, an individual, owns 100% of Nismo Inc., which is a C corporation. Vanessa sells 90 percent of her Nismo Inc. stock to Cars Corp., which is also a C corporation. Cars Corp., Vanessa, and Nismo Inc. may not make a Section 338(h)(10) election because the seller, Vanessa, does not meet the definition

46. I.R.C. § 338(d)(3); Treas. Reg. § 1.338–3(b) (2006) ("an individual cannot make a qualified stock purchase of target").

47. *See* I.R.C. § 338(d)(3) (qualifying transactions require the stock of "1 corporation" acquired by "another corporation").

48. Treas. Reg. § 1.338(h)(10)–1(c) (2010).

49. I.R.C. § 338(h)(10)(B).

50. *Id.*

51. Nitti, *supra* note 8. "By limiting the eligible types of targets in a Section 338(h)(10) transaction to the three types of corporations listed above, it is ensured that the deemed liquidation will not result in a second taxable transaction." *Id.*

52. I.R.C. § 1504(a)(1)–(2).

of a seller under Reg. Section 1.338(h)(10)–1(c). Nismo Inc. is a C corporation, which means that to qualify for the § 338(h)(10) election, the seller must be another corporation that has Section 1504 control of Nismo Inc. Here, Nismo Inc. is owned by Vanessa, an individual, so this will not meet the requirements for a 338(h)(10) election.

1. Qualified Stock Purchase

A Section 338(h)(10) election applies in the case of a stock purchase; however, the rules require something more specific. The stock purchase must be a "qualified stock purchase" ("QSP"). The term qualified stock purchase is defined as "any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12-month acquisition period."[53]

Per this definition, the stock purchase must satisfy each of the following three elements of a qualified stock purchase: (1) purchaser must "purchase" the stock; (2) purchaser must purchase a sufficient amount of stock to meet the control requirements under Section 1504(a)(2); and (3) the purchase must be made within a period of 12 months.[54] Each element is subject to the specific rules and limitations discussed below.

a. Must "Purchase" the Stock

Section 338(h)(3)(A) sets forth definitions and special rules applicable in determining whether a transaction is a qualifying stock purchase for purposes of an election. A "purchase" is defined as:

> [A]ny acquisition of stock, but only if—(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent), (ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any

53. I.R.C. § 338(d)(3) (requiring a taxable purchase of at least 80 percent of a US target corporation within a 12-month period).
54. *Id.*

> other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and (iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock.[55]

The definition of the term "purchase" is exclusive and exhaustive in the sense that a purchase is any transaction whatsoever, except for the three types of transactions described in subsections (i) through (iii) of Section 338(h)(3)(A). The three exclusions are: (1) if the purchaser's basis in the target stock is determined with respect to the basis of the stock in the hands of the transferor; (2) the stock is acquired in a transaction described in Sections 351, 354, 355, or 356; and (3) the stock is acquired in a related party transaction.[56]

Essentially, this means purchaser must acquire at least 80 percent of the target company stock in a *taxable* acquisition.[57] If the stock is purchased in any of the excluded transactions described above, Section 338(h)(3)(A) disqualifies it, and it is not a qualified stock purchase.

b. Purchase Meeting Section 1504(a)(2) Control

The term qualified stock purchase is defined through a cross reference to Section 1504(a)(2), which requires ownership of stock of "at least 80 percent of the total voting power of the stock" and "a value equal to at least 80 percent of the total value of the stock" of the target corporation.[58] Nonvoting, nonconvertible preferred stock is excluded from stock considered in calculating the 80 percent threshold requirement.[59] As the rules are applied to S corporations, the purchaser must acquire at least 80 percent of the S corporation's outstanding stock in order to be sufficient as a qualified stock purchase.

55. I.R.C. § 338(h)(3)(A).
56. *Id.*
57. Nitti, *supra* note 28.
58. I.R.C. § 1504(a)(2).
59. *See* I.R.C. § 1504(a)(4). This requirement is moot in the case of a stock acquisition of an S corporation because S corporations are only permitted to have one class of stock.

c. Within a 12-Month Period

The 80 percent threshold can be satisfied in "any transaction or series of transactions" so long as they occur within the 12-month acquisition period (also known as a creeping stock purchase). "The term '12-month acquisition period' means the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase."[60] Essentially, this is the 12-month period prior to the date that purchaser acquires 80 percent ownership in the target corporation. Thus, to be considered a qualified stock purchase, the purchaser must acquire control (*i.e.*, 80 percent of stock by vote and value) of the target corporation and this can take place in a series of transactions, over time, but it must be within a 12-month period. "[T]he first day on which there is a qualified stock purchase with respect to the stock of such corporation" is the "acquisition date."[61] Although the Section 338 Regulations provide that a so-called creeping stock purchase may satisfy the requirements of a qualified stock purchase, a creeping QSP of an S corporation is not possible.[62]

In the case of a corporate purchaser buying the stock of an S corporation target, the stock purchase can only be a "qualified stock purchase" if the purchaser purchases at least 80 percent of the stock of the S corporation in a single transaction, *i.e.*, on the "acquisition date" only. The Section 338(h)(10) election is only available if the target S corporation holds valid S corporation status on the acquisition date. S corporation status will be invalid if any of the owners of the S corporation become ineligible shareholders before that date.[63] Keeping in mind that a corporation is an ineligible shareholder of an S corporation if, for example, a corporate purchaser were to purchase any of the S corporation's stock prior to the acquisition date, the target's S corporation election would terminate upon the first stock purchase, before the purchaser could make it to the "acquisition date," at which point in time the Section 338(h)(10) election would already be unavailable due to the earlier termination of the S corporation election. Since the Section 338(h)(10) election may only be

60. I.R.C. § 338(h)(1).
61. I.R.C. § 338(h)(2).
62. Nitti, *supra* note 28.
63. Phillip Elefonte, *Inadvertent S Corp. Terminations*, THE TAX ADVISER (Oct. 1, 2012), https://www.thetaxadviser.com/issues/2012/oct/clinic-story-11.html.

entertained by a purchaser who is a corporation, the acquisition of S corporation stock using the Section 338(h)(10) election can never be structured as a series of transactions occurring on different dates because the S corporation election will always bust as of the consummation of the first stock acquisition.[64]

As a result, the 12-month period requirement becomes somewhat irrelevant when the target is an S corporation. If a purchaser wants to acquire an S corporation target using the Section 338(h)(10) election, the qualified stock purchase must simply occur in a single transaction, on the acquisition date.

2. *Consent Requirements*

The Section 338(h)(10) election must be made jointly by the purchaser and the seller (or sellers). In the case of an S corporation target, the sellers are the S corporation shareholders. The Regulations provide that *all* shareholders of the S corporation must consent to the election including shareholders who do not sell their target stock in the qualified stock purchase.[65]

3. *Manner and Timing of Making the Section 338(h)(10) Election*

The Section 338(h)(10) election must be made no later than the 15th day of the ninth month beginning after the end of the month in which the qualified stock purchase is completed (*i.e.*, counting from the month immediately following the acquisition date).[66] The election is made jointly by purchaser and seller on Form 8023, and on behalf of the target corporation.[67] Once the Section 338(h)(10) election is made, it becomes irrevocable.[68] In the case of an S corporation target, the target's S corporation status continues in effect through the close of the acquisition date.[69]

Example 5: Consider the same facts as in Example 4(a). If the qualified stock purchase is completed on January 20, 2023, Lekko

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64. Nitti, *supra* note 28.
65. Treas. Reg. § 1.338(h)(10)–1(c)(3).
66. *Id.*
67. *Id.* If target is an S corporation, the principles of §§ 1.338–2(c)(10) and 1.338–10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale tax consequences are reported. *Id.*
68. Treas. Reg. § 1.338(h)(10)–1(c)(4).
69. Treas. Reg. § 1.338(h)(10)–1(d)(3) (including the time of the deemed asset sale and the deemed liquidation).

Corporation and RIZ Inc. must jointly file Form 8023 by October 15, 2023, based on the January 20 acquisition date.

In addition to filing Form 8023 by October 15, RIZ Inc. must also attach Form 8883, Asset Allocation Statement Under Section 338,[70] to its final Form 1120-S (U.S. Income Tax Return for an S Corporation), which is due by April 15 (the 15th day of the third month following January 20, the date of the stock purchase). Under these facts, RIZ Inc.'s final Form 1120-S (and any applicable built-in gains tax paid with that return) is due *before* Form 8023 on which the Section 338(h)(10) election is made. If Lekko Corporation files a consolidated return with RIZ Inc., Form 8883 is attached to the consolidated return that includes the first day after the acquisition date. Otherwise, Form 8883 is attached to RIZ Inc.'s first Form 1120-S and to Lekko Corporation's Form 1120. Because RIZ Inc.'s final Form 1120-S is due before Form 8023, RIZ Inc. would normally file its final Form 1120-S and, if required, pay any applicable built-in gains tax before the due date of the Form 8023 on which the Section 338(h)(10) election is made. Even if RIZ Inc. extends the due date of its final Form 1120-S, both forms would be due at the same time. However, the extension to file does not extend the time to pay any applicable built-in gains tax.

D. Section 336(e) Election

Under Section 336(e), if

> (1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and (2) such corporation sells, exchanges, or distributes all of such stock, an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.[71]

The Section 336(e) election is similar to a Section 338(h)(10) election, but it applies in situations when Section 338(h)(10) would not apply. A stock sale can qualify for the Section 336(e) election if

70. Form 8883 is used to report information about transactions involving the deemed sale of corporate assets under I.R.C. Section 338. This includes information previously reported on Form 8023, which is used for elections under I.R.C. Section 338 for corporations making qualified stock purchases.

71. I.R.C. § 336(e).

it satisfies the requirements of a "qualified stock disposition", which is similar to a qualified stock purchase under Section 338 because both require the disposal of 80 percent of target stock within a 12-month period, but it is broader because the Regulations under Section 336 have a broader definition of what applies as a qualified stock disposition. Additionally, the Section 336(e) election is more expansive because the identity of the purchaser is not restricted, nor is the number of purchasers.[72] Thus, the seller and the target corporation may be able to make an election under Section 336(e) if the Section 338(h)(10) or Section 338(g) elections are unavailable.[73]

On May 10, 2013, the U.S. Treasury Department promulgated final Regulations under Section 336(e). The proposed Regulations under Section 336 did not make the Section 336(e) election available with respect to the sale of stock of an S corporation. Due in large part to the fact that the Section 336(e) regime was modeled on Section 338(h)(10), the final Regulations effectively extended the Section 336(e) election to S corporations.[74] The final Regulations are generally effective for "qualified stock dispositions" taking place on or after May 15, 2013. Just as a corporation can make the Section 338(h)(10) election in conjunction with a qualified stock purchase of an S corporation, the Section 336 final Regulations authorize a Section 336(e) election in the case of a stock sale that is a qualified stock disposition involving an S corporation as the target.[75]

Although a Section 336(e) election is broader than its Section 338(h)(10) counterpart, many of the same principles, rules, and regulations apply. Generally, the final Regulations under Section 336 are drafted to coincide with Section 338 and in most cases adopt a Section 338(h)(10) model.[76] Thus, a valid Section 336(e) election has the same effect as the Section 338(h)(10) election in that both cause certain stock acquisitions of a target corporation to be treated as a deemed asset acquisition for tax purposes.

72. Hamill, *supra* note 29, at 75.

73. For example, if there is a non-corporate buyer or multiple buyers.

74. Regulations Enabling Elections for Certain Transactions Under Section 336(e), 78 Fed. Reg. 28467-01, 28471 (May 15, 2023) (to be codified at 26 C.F.R. part 1).

75. Under Treas. Reg. § 1.336-1(b)(3), the definition of target includes S corporations.

76. Treas. Reg. § 1.336–1(a) ("[T]o the extent not inconsistent with section 336(e) or these regulations, the principles of section 338 and the regulations under section 338 apply for purposes of these regulations.").

To be eligible for the Section 336(e) election, the target company must be either a domestic C corporation or a domestic S corporation.[77] The seller must be either a domestic C corporation or, if the target is an S corporation, all of the stockholders of an S corporation.[78] Similarly to the Section 338(h)(10) election, in the case of a Section 336(e) election with an S corporation target, the S corporation shareholder sellers include not only those shareholders that sell their stock in the transaction, but *all* of the S corporation shareholders, even those that do not sell their S corporation target stock in the transaction.[79]

The Section 336(e) election enlarges the categories of stock transactions that can be structured as asset acquisitions for tax purposes. In particular, a Section 336(e) election can apply to stock sales to non-corporate purchasers and stock transactions with multiple purchasers.[80] Essentially, the purchaser or purchasers can be corporations, partnerships, LLCs, individuals, or any combination of the foregoing.

1. *Qualified Stock Disposition*

A Section 336(e) election requires a qualified stock disposition, which is defined as "any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition . . . during the 12-month disposition period."[81]

Per this definition, the stock sale must satisfy each of the following three elements of a qualified stock disposition: (1) the stock is transferred in a disposition; (2) a disposition of stock in an amount meeting the 80 percent control requirements under Section 1504(a)(2); and (3) the disposition must be made within a

77. *See* Treas. Reg. § 1.336–1(b)(3).
78. *See* Treas. Reg. § 1.336–1(b)(1) (Generally, all members of a consolidated group that dispose of target stock are treated as a single seller."); *see* Treas. Reg. § 1.336–2(g)(2).
79. *See* Treas. Reg. § 1.336–2(h)(3)(i).
80. *See* Treas. Reg. § 1.336–1(b)(2) (The Section 336 election is available to "one or more persons that acquire or receive the stock of another corporation in a qualified stock disposition.").
81. Treas. Reg. § 1.336-1(b)(6).

period of 12 months. Each element is subject to the specific rules and limitations discussed below.[82]

a. A "Disposition" of the Stock

The term disposition is defined as "any sale, exchange, or distribution of stock, but only if:" (1) the purchaser's basis in the target stock is not determined with respect to the basis of the stock in the hands of the transferor; (2) the stock is not transferred in a transaction covered by Sections 351, 354, 355, or 356; and (3) the stock is not transferred to a related person.[83] Generally, this requires a *taxable* sale, exchange, or distribution of the target stock to an unrelated party. A qualified stock disposition under Section 336(e) is broader than a qualified stock purchase under Section 338(h)(10) because a qualified stock disposition can be a combination of stock distributions, stock exchanges, *and* stock sales. Notably, if a stock disposition meets the definition of both a qualified stock disposition and a qualified stock purchase, the overlap rule in Treas. Reg. Section 1.336-1(b)(6)(ii)(A) provides that it will not be treated as a qualified stock disposition, and the Section 338(h)(10) election would be made in lieu of the Section 336(e) election.[84] In other words, Section 338(h)(10) and the qualified stock purchase rules take precedence over Section 336(e) and qualified stock dispositions. If a transaction qualifies for both elections, the Section 336(e) election becomes unavailable, and Section 338 and the corresponding Regulations are used to determine the tax effect of the transaction.[85]

b. Disposition Meeting Section 1504(a)(2) Control

The term qualified stock disposition is defined through a cross-reference to Section 1504(a)(2), which requires ownership of stock of "at least 80 percent of the total voting power of the stock" and "a value equal to at least 80 percent of the total value of the stock" of

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82. *Id.;* Treas. Reg. § 1.336–1(b)(5).
83. Treas. Reg. § 1.336–1(b)(5).
84. Treas. Reg. § 1.336-1(b)(6)(ii)(A) (providing that if a transaction qualifies as a Section 338(h)(10) transaction, then it cannot be a qualified stock disposition under Section 336(e)); *see* Matthew J. Mittman, CPA, Oak Brook, Ill., *Final Sec. 336(e) Regulations: Election for Qualified Stock Dispositions*, THE TAX ADVISER (September 1, 2013), https://www.thetaxadviser.com/issues/2013/sep/clinic-story-01.html.
85. *See infra* Section 0.0. (comparing the Section 338(h)(10) election to the Section 336(e) election).

the target corporation.[86] Nonvoting, nonconvertible preferred stock is excluded from stock considered in calculating the 80 percent threshold requirement.[87] As the rules are applied to S corporations, the S corporation shareholders must dispose of at least 80 percent of the S corporation's outstanding stock in order to be sufficient for a qualified stock disposition.

c. Within a 12-Month Period

A qualified stock disposition can occur in several transactions with different purchasers on different dates. A fundamental difference between the Regulations under Section 338(h)(10) and the Regulations under Section 336(e) for S corporations is that only Section 336(e) creates the possibility of a deemed sale election as a result of multiple dispositions of S corporation stock occurring on more than one day during the disposition period.[88]

2. Consent Requirements

The Section 336(e) election is, in a sense, a unilateral election because it is made by the selling group, yet without the purchaser's consent; however, it is a joint election because it must be elected jointly by the members of the selling group (*i.e.*, the seller and the target corporation).[89] Thus, in the sale of an S corporation, the Section 336(e) election must be made jointly by the target S corporation and *all* of the shareholders of the S corporation. Even the S corporation shareholders who are not participating in the qualified stock disposition must consent to the election. "The fact that all the shareholders, including those that did not sell stock, must approve the Sec. 336(e) election is reasonable and prevents a tax burden from being assessed on a nonparticipating shareholder."[90]

86. I.R.C. § 1504(a)(2).
87. *See* I.R.C. § 1504(a)(4).
88. I.R.C. § 336(e); Treas. Reg. § 1.338(h)(10).
89. Treas. Reg. § 1.336–1(h).
90. Edward J. Schnee & W. Eugene Seago, *Maintaining Single Taxation: Sec. 336(e) and S Corporations*, THE TAX ADVISER (Mar. 1, 2014), https://www.thetaxadviser.com/issues/2014/mar/schnee-mar2014.html.

3. Manner and Timing of Making a Section 336(e) Election

The seller shareholders and target S corporation must enter into a binding, written agreement to make a Section 336(e) election on or before the due date of the U.S. federal income tax return of the S corporation target for the taxable year that includes the disposition date.[91]

E. Comparison of Section 338(h)(10) Election to Section 336(e) Election

Like a Section 338(h)(10) election, a Section 336(e) election can be beneficial when an asset sale would be preferable but other factors require a stock transaction. Sections 336(e) and 338(h)(10) both allow taxpayers to elect to treat the sale of a target company's stock as the sale by the target company of its assets followed by a liquidation of the target.

A Section 336(e) election generally cannot be made if a Section 338(h)(10) or Section 338(g) election could be made.[92] As a result, the Section 336(e) election expands the categories of stock transactions that can be structured as asset acquisitions for tax purposes. Section 336(e) is broader and more expansive than Section 338(h)(10) because a Section 338 election only applies to a *purchase* of stock; whereas the Section 336(e) election applies to sales, exchanges, and dispositions of stock. Although both Section 336(e) and Section 338 look to the same 80 percent of target stock standard, a "qualified stock disposition" looks to the transferor while a "qualified stock purchase" looks to the purchaser. Another major difference between these sections is that Section 338(h)(10) requires the stock sale to be to another corporation, while Section 336(e) does not restrict the entity of the purchaser. Under Section 336(e), purchasers can be corporations, partnerships, LLCs, trusts, individuals, or any combination of the foregoing. Additionally, a Section 336(e) election can apply to transactions with multiple purchasers.[93]

Generally, if a transaction is a Section 336(e) "qualified stock disposition" as well as a Section 338 "qualified stock purchase," the

91. Treas. Reg. § 1.336–1(h)(3).
92. Treas. Reg. § 1.336-1(b)(6)(ii); Treas. Reg. § 1.336-1(b)(6)(ii)(A).
93. The Section 336 election is available to "one or more persons that acquire or receive the stock of another corporation in a qualified stock disposition." Treas. Reg. § 1.336–1(b)(2).

transaction is not a qualified stock disposition, and the Section 336 Regulations indicate that only the Section 338 election is available. Thus, the parties cannot bypass Section 338 by using a Section 336(e) election instead.

Example 6: Consider the facts from Example 4(a). Since Lekko Corporation is a corporation (rather than a partnership), Lekko Corporation cannot tell Izabella to make a Section 336(e) election instead of a Section 338 election because Lekko Corporation would have to go with the Section 338 election.

IV. DECISION TO MAKE SECTION 338(H)(10) OR SECTION 336(E) ELECTION

The decision of whether it is more advantageous and to what extent an S corporation should sell its assets or its stock, and in the case of a stock sale whether to make an Election, will require the consideration of the following tax issues:

A. Due Diligence of Valid S Corporation Status

The purchaser of stock in an S corporation should ensure the initial and continuing qualification of the target entity as an S corporation. This may require that the S corporation sellers produce documentation evidencing a valid S corporation election and continuing status. The S corporation sellers may also be asked to make several representations and warranties in the purchase agreement as to the target entity's S corporation status.[94]

B. Evaluation of Fair Market Value and Tax Basis

A Section 338(h)(10) or Section 336(e) election only makes sense if the fair market value of the target corporation's assets exceeds the target corporation's aggregate tax basis in such assets. This is because the purchaser should only pursue the deemed asset acquisition if the purchaser obtains a corresponding stepped-up basis in the target corporation's assets. If the purchaser acquires assets from target corporation at a time when the target corporation's basis in its assets exceeds the fair market value of the assets, a stock purchase with a Section 338(h)(10) or Section 336(e) election results in adverse tax consequences to the

94. Hamill, *supra* note 29.

purchaser in the form a "stepped-down" basis in the acquired assets.[95] Thus, in an economic downturn, a purchaser may prefer to structure an acquisition as a stock acquisition without a Section 338(h)(10) or Section 336(e) election.

C. Comparison of Inside Basis Versus Outside Basis

The relative attractiveness of either a Section 336(e) or Section 338(h)(10) election depends on whether the S corporation shareholders' basis in the target S corporation stock is significantly lower than target S corporation's basis in its assets. S corporation target shareholders will be disinclined to agree to an asset acquisition if the S corporation holds ordinary income assets and the shareholders have a higher outside stock basis in the S corporation shares as compared to the aggregate inside basis the S corporation has in its assets. This would result in ordinary income and capital loss to the S corporation shareholders in a transaction structured as an asset acquisition—an undesirable result for the S corporation shareholders, who would be taxed a higher tax rate on their ordinary income and also might not have capital gains to offset the capital losses.[96] In such a case, the S corporation shareholders would insist on a stock acquisition without an Election.

D. Character of Gain Differential Between Stock Sale and Asset Sale

An asset acquisition and a stock acquisition generally result in the same aggregate gain to an S corporation's target shareholder. However, the amount of tax on such gain will depend on the type of assets being sold and the resulting character of gain or loss on a sale of assets.

If a substantial amount of the assets held by an S corporation would be subject to ordinary income characterization, an asset acquisition would result in both ordinary income and capital gains to the S corporation shareholders, while a comparable stock acquisition would result in only capital gain to the S corporation shareholders.[97] Thus, in this case, the S corporation shareholders

95. *See* Greenberg & Davis, *supra* note 13.
96. *Id.*
97. *Id.*

would likely prefer a stock acquisition because the long-term capital gains are subject to preferential tax rates, and an S corporation shareholder would want to ensure that *all* (instead of just some) of its gains on sale are eligible for preferential tax treatment.[98]

For example, suppose an S corporation, who is a cash method taxpayer, has the following assets: inventory with a basis of $50 and a fair market value of $150, and accounts receivable with a $0 basis and value of $100. If the S corporation shareholder sold its stock for a purchase price of $250 and a valid Election were made to treat the stock sale as an asset sale, the S corporation shareholder would recognize $200 of gain, all of which would be ordinary income, taxable at a rate of 39.6 percent (if the QBI deduction does not apply), resulting in $79.20 of tax. On the other hand, if the S corporation's only assets were capital assets, such as two tracts of land with the same basis and fair market value as above, the asset sale would result in the same $200 of gain, but it would be taxable at the capital gain rate of 20 percent, resulting in only $40 of tax.

E. Corporate Level Tax Triggered in Deemed Asset Sale

S corporations are pass-through entities, which are not usually subject to corporate-level taxes.[99] However, in certain circumstances, corporate level taxes may be imposed upon an S corporation under I.R.C. Section 1374. Section 1374 imposes a corporate level tax upon the disposition of built-in gain assets by an S corporation in the following situations: (i) if the S corporation was previously a C corporation that elected S corporation status after formation (*i.e.*, a converted S corporation) and it retained assets from the time it was a C corporation;[100] or (ii) if the S corporation acquired built-in gain assets from a C corporation in a tax-free, transferred basis transaction.[101]

The Section 1374 built-in gain tax is applicable for any disposition of built-in gain assets by the S corporation during the

98. *Id.*
99. Although S corporations are not subject to corporate income tax at the Federal level, they may be subject to corporate taxation at the state or municipal level. A discussion regarding the imposition of such state and local corporate taxation is beyond the scope of this article.
100. I.R.C. §§ 1374(a)–(d).
101. I.R.C. § 1374(d)(8); Treas. Reg. § 1.1374–8(a).

five-year period starting with the first day of the first taxable year that the corporation was an S corporation or the date the S corporation acquired the built-in gain assets from a C corporation.[102] Built-in gain is "measured by the appreciation of any asset over its adjusted basis at the time the corporation converts from C corporation to S corporation status (or acquires assets from a C corporation in a tax-free transaction)."[103]

The disposition of built-in gain assets during the applicable five year period will require corporate level gain recognition taxable to the S corporation at the highest tax rate applicable to corporations, which is currently a 21 percent tax rate. In addition, the built-in gain is passed through and recognized by the S corporation shareholders under Section 1366. The character of the shareholder level gain is determined by reference to the asset disposed of, reduced by Section 1366 losses.[104]

If the S corporation target holds assets with built-in gain subject to Section 1374, a stock acquisition with a Section 338(h)(10) or Section 336(e) election will trigger a built-in gains tax. A stock acquisition without a Section 338(h)(10) or 336(e) election generally will not trigger the built-in gains tax under Section 1374.

Example 7. Consider the facts from Example 3, except that RIZ Inc. was formed a C corporation in 2010 and elected S corporation status on January 1, 2020. At the time of its conversion to S corporation status, RIZ Inc. has only two assets, equipment and land. The equipment has a basis of $120,000 and a fair market value of $400,000, and the land has a basis of $180,000 and a fair market value of $600,000. On January 1, 2021, Izabella sells her RIZ Inc. stock to Lekko Corporation for $1,000,000 (when the basis and the value of the assets remain the same as at the time of conversion). If a valid Section 336(e) or Section 338(h)(10) election

102. I.R.C. §§ 1374(d)(7)-(8).

103. I.R.C. § 1374(d)(3); Potter, *supra* note 7 at *7.

104. Potter, *supra* note 7, at *6. "If the S corporation was a C corporation previously, the built-in gains at conversion that are recognized during the recognition period are subject to a corporate-level tax. If the stock sale occurs during the recognition period, the deemed asset sales generate taxable built-in gains. The tax liability is a corporate liability. Therefore, the ADADP is increased by this tax liability. If the corporation owns assets that have declined in value and/or has a net operating loss carryforward, the amount of tax due on the built-in gains from these deemed asset sales may not be equal to the net gain times the highest corporate tax rate. The gains and losses from the deemed asset sales by an S corporation (modified by the built-in gains tax) pass through and are recognized by the shareholders." Schnee & Seago, *supra* note 90, at 3.

were made, RIZ Inc. would be liable for built-in gain tax on the $280,000 of built-in gain on the equipment and $420,000 of built-in gain on the land, as measured at the time of conversion. In the deemed asset sale, the tax liabilities of RIZ Inc., including the built-in gains tax realized on the deemed asset sale, remain the liability of RIZ Inc., which means that purchaser of RIZ Inc. would be liable for built-in gain taxes under Section 1374 on the $700,000 of built-in gain as a result of RIZ Inc.'s conversion from C corporation to S corporation status prior to the acquisition.

Accordingly, in determining whether to structure an acquisition as an asset sale or a stock sale with a corresponding Election, a purchaser must consider the possible existence of any built-in gains on corporate assets, as well as the existence of unfavorable tax attributes such as earnings and profits. "To the extent any corporate-level taxes may apply, the seller would also be affected. . . ."[105]

F. Purchase Price Considerations

If the purchaser and sellers agree to proceed with an Election under either Section 338(h)(10) or Section 336(e), the sellers should insist thatthe purchaser gross-up the purchase price for any additional tax liabilities associated with the Election. This gross-up payment should include taxes that will be incurred by the S corporation shareholders as a result of the transaction being treated as an asset sale for tax purposes (on which the seller shareholders may recognize ordinary income) rather than a stock sale on which the shareholders would only recognize capital gain.[106] If the step-up in tax basis for the purchaser has a net present value that exceeds the gross-up payment requested by the sellers, the purchaser should agree to the increase in purchase price.[107] This gross-up payment is the reason S corporation shareholders are generally indifferent in terms of structuring the transaction as either an asset or a stock sale. Although sellers prefer the stock sale, they will agree to a purchaser's proposition to treat the stock sale as an asset sale for tax purposes if the gross-

105. Hamill, *supra* note 29, at 65.
106. *See* Potter, *supra* note 7, at *3.
107. *See id.* at *5. Alternatively, the gross-up payment may result in the Election being cost-prohibitive if it exceeds the step-up in tax basis. *See id.* at *4.

up payment makes up for any additional taxes sellers may incur from the Election.

V. EFFECT OF SECTION 338(H)(10) AND SECTION 336(E) ELECTIONS

The impact of an election under either Section 338(h)(10) or Section 336(e) will generally have a similar effect—the transaction will be treated as a deemed asset sale, typically followed by a complete liquidation.[108] A single level of tax is imposed at the entity level. The stock sale is ignored for tax purposes. Instead, the target corporation is treated as making a deemed sale of its assets and then liquidating.[109]

An Election creates a tax fiction that treats a qualified stock purchase (in the case of a Section 338(h)(10) election) or a qualified stock disposition (in the case of a Section 336(e) election) of target corporation as a deemed asset sale of the "Old Target" assets to a new and fictional "New Target," both of which are legally the same entity but generally different corporations for federal tax purposes.[110] An Election with an S corporation target has the following effect:

Step 1. Old Target (while Old Target is owned by S corporation shareholders) is deemed to sell all of its assets to New Target in exchange for the negotiated consideration plus any liabilities assumed,[111] which is the aggregate deemed sale price ("ADSP") under Section 338 or the aggregate deemed asset disposition price ("ADADP") in the case of a Section 336(e) election.[112] Old Target recognizes gain or loss on this deemed asset sale (equal to the consideration received plus liabilities assumed less tax basis of target corporation's assets), which passes through to all the S corporation shareholders.[113]

108. Treas. Reg. §1.336-1(a)(1) (providing that generally, except to the extent inconsistent with section 336(e), the results of section 336(e) should coincide with those of section 338(h)(10)); *see* Schnee & Seago, *supra* note 90.

109. *See* Horacio Sobol, Ryan Prillaman, & Sam Starr, *Section 336(e) Deemed Asset Acquisitions and S Corporations*, BLOOMBERG BNA - DAILY TAX REPORT (Mar. 31, 2014).

110. Treas. Reg. § 1.338(h)(10)–1(d); *see also* Potter, *supra* note 7, at *11.

111. Treas. Reg. §§ 1.338(h)(10)–1(d)(3); *see also* Potter, *supra* note 7, at *4.

112. *See* Treas. Reg. § 1.338(h)(10)–1(d)(3) (for § 338(h)(10) election); § 1.336–2(b)(1)(i)(A) (for §336(e) election); *see also* Schnee & Seago, *supra* note 90, at 2. If the stock is sold (rather than distributed under § 336(e)), the ADADP under § 336(e) will equal the ADSP under §338(h)(10). *Id.*

113. Treas. Reg. § 1.338(h)(10) –1(d)(5)(i).

Step 2. New Target, owned by the purchaser, is deemed to purchase the Old Target's assets and assume its non-tax liabilities from an unrelated seller for the adjusted grossed-up basis ("AGUB").[114] AGUB is the grossed-up basis of the purchased target corporation stock, plus the liabilities of New Target.[115] AGUB is allocated to the individual assets under the residual method set forth in Treas. Reg. Section 1.338–6.[116]

Step 3. Old Target is deemed to liquidate, distributing the sale proceeds from the deemed asset sale to its shareholders.[117] Following the deemed sale by the target of all its assets, the target is deemed to have liquidated, which is treated as a taxable liquidation under Sections 331 and 336.[118] Old Target does not recognize any gain or loss on the liquidation, because of the basis step-ups to target assets and to target stock.[119]

Example 8. Consider the facts from Example 4(a). Upon making a Section 338(h)(10) election, old RIZ Inc. is deemed to sell all of its assets to new RIZ Inc. in exchange for the negotiated consideration of $1,000,000. Old RIZ Inc. recognizes $700,000 of income, which is passed through to Izabella and increases Izabella's stock basis in old RIZ Inc. After the deemed asset sale, RIZ Inc. is treated as a new corporation and new subsidiary of Lekko Corporation for tax purposes. New RIZ Inc. (owned by Lekko Corporation) is deemed to purchase old RIZ Inc.'s assets and assume its non-tax liabilities from an unrelated seller for the AGUB, which is also equal to $1,000,000. Old RIZ Inc. is deemed to liquidate.

A. Deemed Asset Purchase Price Allocation

If either a Section 338(h)(10) or Section 336(e) election is made, the parties must allocate the purchase price, *i.e.*, the ADSP (for a Section 338(h)(10) election) or the ADADP (for a Section 336(e) election), among the basis of the various target assets

114. Treas. Reg. §§ 1.336-2(b)(1)(ii), 1.338(h)(10)–1(d)(2). "The AGUB for new T's assets is determined under § 1.338–5 and is allocated among the acquisition date assets under §§ 1.338–6 and 1.338–7." Treas. Reg. § 1.338(h)(10)–1(d)(2).

115. Treas. Reg. § 1.338–5(b)(1).

116. Treas. Reg. 1.338(h)(10)–1(d)(2). The AGUB in a § 336(e) election is calculated the same as the AGUB in a § 338(h)(10) election and is allocated under Treas. Reg. § 1.338–6. Treas. Reg. §§ 1.336–2(b)(1)(ii), 1.336–4.

117. Treas. Reg. §§ 1.338(h)(10)–1(d)(4)-(5), 1.336–2(b)(1)(iii).

118. Treas. Reg. § 1.336–2(b)(1)(iii); *see also* Schnee & Seago, *supra* note 90.

119. Treas. Reg. § 1.338(h)(10)–1(d)(5); Potter, *supra* note 7.

acquired in accordance with the residual method of valuation.[120] The ADSP or ADADP is allocated among the first six classes in the order listed, and if there remains additional consideration, it is then allocated to the residual category under class seven. The seven classes listed in order are:

(1) Cash and demand deposits;

(2) Actively traded personal property, including certificates of deposit and foreign currency;

(3) Assets the value of which is marked-to-market and debt instruments, including accounts receivable;

(4) Inventory;

(5) All assets that are not classified in any other category;

(6) Code Section 197 intangibles (other than goodwill or going concern value); and

(7) Goodwill and going concern value.[121]

"Allocated gain or loss is characterized by reference to the nature of the corporation's purpose in holding the particular assets sold."[122] This will likely cause some portion of the reported gain to be ordinary income, or perhaps unrecaptured Section 1250 gain, rather than 20 percent capital gain. "Target shareholders typically require additional sales consideration to compensate for the added tax burden, which becomes a deal point in negotiations to make an Election election."[123]

B. Deemed Asset Sale Tax Treatment for S Corporation and Shareholders

In general, the tax consequences of an asset sale by an S corporation are relatively straightforward because the S corporation itself is a pass-through entity and is generally not

120. I.R.C. § 1060; Treas. Reg. §§ 1.338–6, 1.338–7.
121. Treas. Reg. § 1.338-6.
122. Looney, *supra* note 42, at 27.
123. Hamill, *supra* note 29, at 74.

treated as a taxable entity for federal income tax purposes, and as such, its shareholders are subject to only one level of tax.[124]

The S corporation election, as explicitly stated by the Regulations, persists till the final day of the deemed asset sale..[125] Since S corporations do not pay federal income tax, as a general rule, the computation of the ADSP or ADADP does not include an adjustment for the tax liability.[126] The gain or loss on a sale of assets by an S corporation will be the difference between the consideration received on the sale from the purchaser and the S corporation's adjusted tax basis in the assets sold, as determined under the general rules of Section 1001.[127] The amount and character of this gain or loss from the deemed asset sale passes through to and is taxed at the shareholder level.[128]

The fact that a shareholder did not sell stock is immaterial. All the shareholders recognize their share of the gains and losses.[129] S corporation shareholders take their pro rata share of the deemed sale tax consequences into account under Section 1366 and increase or decrease their basis in target entity stock under Section 1367. Because Old Target is an S corporation, the shareholders' adjusted tax basis in their Old Target shares is adjusted (*i.e.*, increased) for any gain recognized by Old Target on the deemed asset sale.[130] After recognizing the gains and losses, the shareholders adjust their basis in the S corporation stock owned before the sale by the amount apportioned to them. They increase their basis by apportioned gains and income, and reduce basis by deductions and losses.[131]

124. Looney, *supra* note 42, at 27. "Where the S corporation has been a qualifying electing small business corporation for its entire history and has not acquired the assets of a C corporation (or an S corporation subject to the built-in gain tax) within the past ten years in an exchanged basis transaction, then the corporate-level tax from the asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax." *Id.*; *see supra* text accompanying note 99.

125. Treas. Reg. § 1.336-2(b)(1)(i).

126. Schnee & Seago, *supra* note 90, at 3. "There are two potential modifications to the ADADP for S corporation taxes. If the S corporation was a C corporation that used the LIFO method at the time of the conversion, the corporation has to pay tax on the LIFO recapture. If the installments have not all been paid at the time of the sale, the remaining installments are corporate liabilities that increase the ADADP. A more important potential adjustment is in Sec. 1374." *Id.*

127. Looney, *supra* note 42, at 27.

128. Potter, *supra* note 7, at *2; Treas. Reg. 1.338(h)(10) –1(d)(5)(i).

129. Schnee & Seago, *supra* note 90.

130. Potter, *supra* note 7, at *4; Treas. Reg. § 1.338(h)(10)–1(d)(5)(i).

131. Schnee & Seago, *supra* note 90 at 3.

Additionally, per I.R.C. Section 199A, individuals are eligible for a 20 percent deduction for certain qualifying business income ("QBI") from flow-through entities, which includes S corporations.[132] If the deduction is available and not restricted by wage and basis limitations, it would reduce the S corporation shareholder's individual maximum tax rate to 29.6 percent on QBI. Notably, certain ordinary income (such as depreciation recapture) from a deemed asset sale would be treated as QBI qualifying for the 20 percent tax deduction.[133] The QBI deduction under Section 199A makes the S corporation competitive with C corporations.

Example 9: Consider the facts from Example 8. RIZ Inc. recognizes $280,000 income ($400,000 amount realized – $120,000 basis) for the sale of the equipment and $420,000 income ($600,000 amount realized – $180,000 basis) for the sale of the land, totaling $700,000 in income, which "flows through" to Izabella (RIZ Inc.'s shareholder), and which increases Izabella's stock basis in RIZ Inc. from $100,000 to $800,000. Izabella is taxed on that $700,000 of gain based on the characterization of such income from the asset to RIZ Inc. The character of the gain will be $150,000 ordinary income (for the equipment depreciation recapture) and the remaining $550,000 as capital gain. The $150,000 in ordinary income is taxed at the maximum individual rate of 29.6 percent (as reduced by the flow through QBI deduction), resulting in $44,400 of tax. The $550,000 taxed at the maximum capital gain tax rate of 20 percent results in $110,000 of tax. Izabella ends up with $154,400 total tax due, which when deducted from the $1,000,000 purchase price, resulting in $845,600 cash on an after-tax basis. When old RIZ Inc. is deemed to distribute the sales proceeds to Izabella, Izabella receives $1,000,000 of cash, which results in $200,000 of capital gain ($1,000,000 cash – $800,000 stepped-up basis in old RIZ, Inc.). Ultimately, Izabella recognizes $900,000 of gain, which is the same amount Izabella would have recognized had this been a stock sale of RIZ Inc. ($1,000,000 AR – $100,000 basis = $900,000 gain).

Notably, S corporation shareholders selling an S corporation will report the same amount of gain on the transaction, whether or not an Election is made. What is different in the case of an asset acquisition versus a stock acquisition is the characterization of

132. Subject to sunset at the end of 2025.

133. Potter, *supra* note 7, at *6; Hamill, *supra* note 29, at 67.

that gain. An Election has the effect of converting some or all of an S corporation shareholder's capital gain from a stock sale into ordinary income in an asset sale. This can occur if the S corporation shareholder has an outside basis equal to or less than the S corporation's inside basis. On the other hand, if the S corporation shareholder's outside basis is greater than the S corporation's inside basis, the S corporation shareholder would report a capital loss. The capital loss serves to offset the additional ordinary income realized by the S corporation on the deemed asset sale, which is also recognized by the S corporation shareholder. "Although the total net income reported by the shareholder is the same, the classification can greatly affect the shareholder's tax liability."[134]

C. Tax Treatment on Liquidation of S Corporation

Immediately following the deemed asset sale, the S corporation is treated as having distributed the amount received from the asset sale to the shareholders, followed by a termination of the S election.[135] In most cases, such a transfer of the cash asset, *i.e.*, the distribution, is treated as a distribution in complete liquidation of the corporation.[136] Because the shareholders of an S corporation are typically individuals, Section 331 governs the liquidation.[137] Such deemed liquidation of Old Target will not usually generate gain because of the stepped-up basis in the S corporation assets and to the S corporation stock. The application of Section 331, rather than Section 332, "is a major difference under Sec. 336(e) for S corporation shareholders that make the election, compared with C corporations that make the election for the sale of a subsidiary."[138]

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134. Schnee & Seago, *supra* note 90.
135. *See* Treas. Reg. § 1.338(h)(10)–1(d)(5).
136. Treas. Reg. § 1.338(h)(10)–1(d)(4) (although the Regulation states it may be treated as a redemption or reorganization).
137. Treas. Reg. § 1.338(h)(10)–1(d)(4). The application of Section 331, rather than Section 332, "is a major difference under Sec. 336(e) for S corporation shareholders that make the election, compared with C corporations that make the election for the sale of a subsidiary." Schnee & Seago, *supra* note 90.
138. Treas. Reg. § 1.338(h)(10)–1(d)(4); Schnee & Seago, *supra* note 90.

D. Tax Treatment to Purchaser of Assets

The tax consequences to a purchaser of assets of an S corporation are simple—the purchaser receives a cost basis in the acquired assets.[139] This means that the purchaser receives a basis in the acquired assets equal to the purchase price paid (plus any assumed liabilities).[140] Because the cost basis is typically higher than the basis the S corporation target had in those assets, a cost basis usually results in a stepped-up basis for the purchaser. The basis is used by the purchaser, among other things, to calculate depreciation and amortization deductions on the acquired assets, as well as to determine gain or loss on the sale or other disposition of the assets in the future. A stepped-up basis translates into significant tax benefits for the purchaser by allowing it to take greater depreciation and amortization deductions on those assets and by reducing the amount of taxable income or gain (or increasing the amount of loss) on a later sale or other disposition of the assets.[141]

1. 100 Percent Bonus Depreciation

One such tax benefit is afforded to the purchaser under I.R.C. Section 168(k), whereby the purchaser can take bonus depreciation in the first year for tangible personal property with a life of 20 years or less.[142] The depreciation percentage is based on the year that the property is purchased and placed in service.[143] Qualifying property placed in service after September 27, 2017, but before January 1, 2023, is eligible for 100 percent bonus depreciation.[144] However, starting on January 1, 2023, full bonus depreciation is phased down at a rate of 20 percent per year until fully phased out after the end of 2026.[145]

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139. I.R.C. § 1012; *see* Greenberg & Davis, *supra* note 13, §4.03(2)(a).
140. Treas. Reg. § 1.338(h)(10)–1(d)(2); *see* Greenberg & Davis, *supra* note 13, §4.03(2)(a).
141. *See* Steven D. Shapiro, *Acquisition Planning for a Tax Basis Step-Up*, FLA. BAR J., Vol. 91, No. 1 (January 2017), https://www.floridabar.org/the-florida-bar-journal/acquisition-planning-for-a-tax-basis-step-up/.
142. I.R.C. § 168(k).
143. *See* Treas. Reg. § 1.168(k)-2(b).
144. *See* Erica York et al., *The Economic, Revenue, and Distributional Effects of Permanent 100 Percent Bonus Depreciation*, TAX FOUND. (August 30, 2022), https://taxfoundation.org/research/all/federal/permanent-100-percent-bonus-depreciation-effects/.
145. *Id*.

The 2017 Tax Cuts and Jobs Act expanded property eligible for bonus depreciation to include certain used property.[146] The purchaser is able to take bonus depreciation on property that is acquired by purchase, provided that the property is not acquired from a related party.[147] Deemed acquisitions of property pursuant to a Section 338(h)(10) election or a Section 336(e) election are subject to the same treatment as actual acquisitions and thus are eligible for Section 168(k) bonus depreciation. The availability of bonus depreciation in such instances is a valuable tax benefit to the purchaser in merger-and-acquisition transactions and can serve as "additional consideration during negotiations."[148]

The ability to deduct 100 percent of a high-priced asset's cost in the year of purchase under Section 168(k) can generate significant tax savings and possibly even refunds for purchaser.[149] A purchaser's tax benefits from the 100 percent bonus depreciation deduction could potentially exceed the tax burden at the shareholder level tax, resulting in no net tax to either party. However, as the phaseout of 100 percent bonus depreciation takes its course and the depreciation percentage decreases from year to year, the tax benefits will also gradually be diminished and eventually completely phased-out.

2. Section 179 Expensing

I.R.C. Section 179 is another immediate expense deduction available to the purchaser, pursuant to which the purchaser can elect to expense the cost of any qualified property and deduct it in the year the property is placed in service.[150] This allows a purchaser to lower its current-year tax liability instead of capitalizing and depreciating the assets over time in future tax years. Section 179 applies to purchases of depreciable business equipment such as office equipment, business machinery,

146. Sharon Kay & Caleb Cordonnier, *Proposed bonus depreciation regs. Provide answers, create new questions*, THE TAX ADVISER (Feb. 1, 2019), https://www.thetaxadviser.com/issues/2019/feb/proposed-bonus-depreciation-regs-provide-answers-create-questions.html.

147. Potter, *supra* note 7, at *6.

148. Kay & Cordonnier, *supra* note 146.

149. *Id.*; *see* Jeremy Sompels et al., *The TCJA 100% bonus depreciation starts to phase out after 2022*, PLANTE MORAN (February 16, 2023), https://www.plantemoran.com/explore-our-thinking/insight/2022/08/the-tcja-100-percent-bonus-depreciation-starts-to-phase-out-after-2022.

150. I.R.C. § 179.

computers, vehicles, or software.[151] The full amount of the purchase price for such purchased equipment is eligible for the Section 179 deduction. The Section 179 deduction is limited to a maximum of $1,160,000 and a value of property purchased to $2,890,000 for the year 2023.[152] The deduction begins to phase out on a dollar-for-dollar basis after $2,890,000 is spent, with the entire deduction becoming unavailable once $4,050,000 in purchases is reached.[153]

E. Impact of Election on Purchase Agreement

Depending on the type of Election available for the acquisition and whether it is beneficial to the parties, counsel on either side of a transaction should ensure that certain specific provisions and items are included in the purchase agreement with respect to making the Election. One such provision that should always be included when the transaction involves an Election is the purchase price allocation, whereby the parties mutually agree to allocate the purchase price to the specific classes of assets acquired in the transaction. Both parties must report the same allocation, so the purchase price allocation schedule is typically agreed upon at or shortly after the closing in accordance with this provision. This provision should indicate where the allocation schedule can be found, which party is responsible for preparing it, when it must be completed, and a dispute resolution procedure in case the parties cannot agree on the allocation scheme. It should also state that the tax returns of both parties must be filed in accordance with the purchase price allocation schedule.

1. Purchase Agreement from Purchaser's Perspective

If the purchaser believes it will benefit from a Section 338(h)(10) election, purchaser's counsel should ensure that the purchase agreement includes a provision whereby purchaser and seller jointly agree to make the Section 338(h)(10) election, if requested by purchaser.[154] This type of provision is beneficial to

151. Publication 946 (2022), How To Depreciate Property, IRS, *available at* IRS.gov/Pub946. *How To Depreciate Property,* I.R.S., at 16 (Feb. 23, 2022), IRS.gov/Pub946.
152. *Id.*
153. *See* Section 179 at a Glance for 2023, SECTION179.ORG, https://www.section179.org/section_179_deduction/ (last visited Aug. 30, 2023).
154. *See* Greenberg & Davis, *supra* note 13, §4.03(2)(a).

the purchaser due to the fact that the Section 338(h)(10) election must be made jointly by purchaser and seller. Binding the seller under the purchase agreement ensures that the seller will proceed with making the Election.

On the other hand, a Section 336(e) election can be made only by seller and without the purchaser's consent. Therefore, if the purchaser performs an evaluation and determines that a Section 336(e) election would cause it adverse tax consequences, purchaser's counsel should consider including a negative covenant in the stock purchase agreement preventing the seller shareholders and target corporation from making a Section 336(e) election.[155]

2. Purchase Agreement from Seller's Perspective

Both Elections can have adverse tax consequences for the seller shareholders, particularly if a substantial amount of the assets held by the S corporation target would be subject to ordinary income characterization, taxed at ordinary income rates to the S corporation shareholders. Therefore, counsel for the seller shareholders should seek that the purchase agreement includes a provision whereby purchaser agrees to make a gross-up payment compensating the sellers for any increased tax liabilities in connection with making the Election. Alternatively, counsel may include an indemnification provision whereby purchaser would be required to indemnify the sellers as a result of any such additional tax liabilities incurred.[156]

VI. EFFECTS OF BIDEN ADMINISTRATION PROPOSED TAX CHANGES

The popularity of the S corporation in the world of mergers and acquisitions stems from current favorable tax rates and the corresponding tax benefits available with this specific form of business entity. The tax benefits available to shareholders and purchasers of S corporations are at risk of being eliminated under President Biden's proposed tax plan. President Biden's tax plan seeks to raise the corporate tax rate from 21 percent to 28 percent and the maximum individual rate from 37 percent to 39.6 percent

155. *Id.* §4.04(2)(e).
156. *Id.* §4.04(2)(e)(a)(i).

for individuals making more than $400,000. Under current law, the top capital gain rate is 20 percent (or 23.8 percent including the NIIT if applicable). Biden's proposed tax plan would eliminate the capital gains preference for those making more than $1 million, thus imposing a tax for taxpayers with over $1 million in income at the top ordinary income rate of 39.6 percent (or 43.4 percent including the NIIT). An additional proposal would increase the NIIT rate by 1.2 percentage points above $400,000, bringing the marginal NIIT rate to 5 percent for investment income above the $400,000 threshold.[157] "Together, the proposals would increase the top marginal rate on long-term capital gains and qualified dividends to 44.6 percent" (*i.e.*, 39.6 percent plus 5 percent NIIT).[158] Thus, "[l]ong-term capital gains and qualified dividends of taxpayers with taxable income of more than $1 million would be taxed at ordinary rates. . . ." [159]= In addition to raising the maximum individual rate, Biden's tax plan aims to eliminate the tax benefits under Section 199A, which is currently available to owners of high-earning passthrough entities, including S corporations. This would be accomplished by phasing out the Section 199A deduction for taxpayers with income of more than $400,000.[160]

An increase in capital gains tax could have a distressing impact on asset and stock acquisitions involving pass-through entities as targets.[161] The phase-out of the QBI deduction for owners of S corporations might make the C corporation a more

157. The proposal would expand the NIIT base to ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or employment taxes under the Self-Employment Contributions Act.

158. General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, DEP'T OF THE TREASURY, at 79 n.20 (March 9, 2023), https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.

159. *Id.* at 79.

160. *M&A Tax Talk: Power Shift, Tax Shift?* DELOITTE (Jan. 2021), https://www2.deloitte.com/us/en/pages/tax/articles/m-and-a-tax-talk.html. "The analysis of different structuring alternatives may also change. If long-term capital gains are taxed at ordinary rates (for certain individuals), sellers may not be as concerned with structuring transactions to achieve capital gains tax treatment. . . . Alternatively, businesses may become more concerned with tax structuring alternatives. For example, a buyer typically favors a structure that is treated as an asset acquisition or deemed asset acquisition because it may deliver a step-up in tax basis. If the rates increase, the tax basis step-up will drive incremental value by providing additional deductions that would offset taxable income subject to higher tax rates." *Id.* at 2.

161. *Election Pivotal for Tax Impact of Future Deals,* GRANT THORNTON LLP (Sept. 18, 2020), https://web.archive.org/web/20201026073114/https://www.grantthornton.com/library/alerts/tax/2020/Insights/election-pivotal-for-tax-impact-future-deals.aspx.

lucrative entity structure as compared to the S corporation, eliminating the ability of S corporations to compete. This is because C corporations are not eligible for the QBI deduction, while S corporations are eligible. The phaseout of the QBI deduction would increase the tax rate on QBI to 39.6 percent (which is equal to the highest individual rate under the Biden tax plan) for taxpayers with income of more than $400,000.[162] "Thus, as with the proposed changes to corporate taxes, the potential phaseout of this deduction increases the income taxes associated with operating a pass-through business."[163] Still, the C corporation may not be a more appealing alternative to the S corporation considering the increased corporate tax rate from 21 percent to 28 percent.

To demonstrate the potential impact of the Biden tax plan on the net proceeds of a sale of business, consider the facts from Example 3(b). Izabella has $900,000 capital gain ($1,000,000 amount realized – $100,000). Additionally, assume Izabella has income from other sources and her total income is greater than $1 million. Under current law, with the capital gains tax rate at 20 percent, the sale would generate $180,000 in taxes due ($900,000 x 20 percent capital gain rate), which results in $720,000 net proceeds to Izabella. Under Biden's proposed tax plan, because Izabella's total income is greater than $1 million, the $900,000 in taxable long-term capital gain would be taxed at 39.6 percent, generating $356,400 in tax, and resulting in $543,600 in net proceeds to Izabella. This would result in $176,400 of additional tax to Izabella versus current law.[164]

VII. CONCLUSION

In conclusion, the unique tax structure of the S corporation, which corresponds with its high popularity as an entity choice, makes the S corporation a likely and worthy target in either an asset acquisition or a stock acquisition. The elections under Section 338(h)(10) and Section 336(e) to treat the stock sale as a

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162. The proposal to repeal the Section 199A deduction for individuals with more than $400,000 in income would raise the top effective rate on qualifying pass-through business income from 29.6% to 39.6%.

163. Crystal Howard, *Biden Victory Tax Concerns Could Spur M&A Activity*, LAW360 (Oct. 30, 2020, 5:53 PM), https://www.law360.com/articles/1324333.

164. *Id.*

deemed asset sale for tax purposes make the stock acquisition of an S corporation even more worthwhile for all parties involved by allowing the transaction to proceed with the ease of transferability of a stock sale, while benefitting from the favorable tax consequences of an asset sale. The proposed increased tax rates, phased-out deductions, and limited tax planning opportunities applicable to S corporations under President Biden's tax plan may diminish the preferred status of the S corporation as a key player in the world of mergers and acquisitions, thereby becoming commensurate with the C corporation from a tax perspective. On the other hand, if long-term capital gains are taxed at the same rates as ordinary income (for certain high income individuals), S corporation sellers may become completely indifferent as to whether a transaction is structured as an asset or a stock sale because both would result in the same tax treatment regardless of the character of assets held by the S corporation; in which case, there would be an absolute alignment between potential purchasers and S corporation sellers for the deemed asset acquisition structure available with the Section 338(h)(10) and Section 336(e) elections.[165] Notably, the increased tax rate for high earning individuals will have the greatest impact in determining whether to acquire the stock or assets of a target entity because the individual tax rates are used to calculate any gross-up in purchase price between the two acquisition structures. Still, the purchaser will continue to benefit from a stepped-up basis in a target entity's assets. Accordingly, the tax rate increases under President Biden's proposed tax plan will make transactions that provide for tax basis increases to assets, such as with deemed asset acquisitions using the Section 338(h)(10) or Section 336(e) election, more attractive for C corporations and S corporations alike.

165. In comparison, the shareholders of a C corporation target would continue to prefer a stock sale to avoid the double taxation that comes with a sale of assets.

COMMUNITY PROPERTY PLANNING IN NON-COMMUNITY PROPERTY STATES & UNDERSTANDING THE FLORIDA COMMUNITY PROPERTY TRUST ACT – OPPORTUNITIES, DEVELOPMENTS, AND TRAPS FOR THE UNWARY

Alan Gassman and Brock Exline

I. KEY TAKEAWAYS:

Before the reader gets bogged down with 100 rules and 300 exceptions, please keep your eyes open for the following key takeaways.[1]

1. **Community Property Defined.** Community property consists of all assets acquired by one or both spouses of a married couple while they reside in a community property jurisdiction.[2] This will include IRAs, assets held in only one spouse's name other than those acquired by gift, bequest, or devise, and the right to receive payment or assets in the future.[3] Gifts of community property typically require the consent of both spouses, and a gift of community property without dual consent of the spouses is voidable by the non-consenting spouse.[4] As a result, a gift lacking

1. Special thanks to Dr. Gerry W Beyer, whose presentation entitled *Community Property: Tips and Traps for Lawyers in Common Law States*, a 2021 presentation at the 47th Annual Notre Dame Tax & Estate Planning Institute was of tremendous help to the authors in the writing of this article. Many of the takeaways in the Notre Dame outline were derived from M. Read Moore and Nicole M. Pearl, *Coming Soon to Your State: Community Property*, ACTEC 2020 Fall Meeting, October 27, 2020.

2. Gerry W. Beyer, *Community Property: Tips and Traps for Lawyers in Common Law States*, 47th Annual Notre Dame Tax & Estate Planning Institute, at 1 (Oct. 22, 2021).

3. *See* IRM 25.18.1.3.10 (Feb. 15, 2005); *e.g.,* 26 U.S.C. § 408(g) (1983) (stating that tax laws apply regardless of whether IRAs are located in, and therefore affected by, community property law jurisdictions).

4. Beyer, *supra* note 2, at 38 (citing Trimble v. Trimble, 26 P.2d 477 (1933)).

consent of both spouses will generally be deemed incomplete for purposes of the federal gift tax.[5]

2. **Selected Definitions**. The following definitions can be helpful.

A. Transmute- to convert the character of community property to another status of ownership. Property can be transmuted from community property to separate property, or from separate property to community property by a couple who lives in a community property jurisdiction.[6] Typically, this occurs through the execution of an appropriate document by a married couple, which may need to be recorded in the public records when dealing with real estate.

B. Mutable. Derived from the Latin root "mut" for "changeable" or "tendency to change," this meaning is found in such words as 'commute, immutable, mutability, transmute, permute, and mutate.' Mutability ("the ability to change") is a fundamental aspect of choice of law principles in the United States which provide that legal rules governing the property of a married couple change depending on the couple's place of residence at different points in time, as further discussed below.[7]

C. Commingle. Commingling refers broadly to the mixing of funds belonging to one party with funds belonging to one or more other parties. Commingling may also refer to the mixing of assets characterized as community property with assets characterized as separate property, such that the original character of the assets mixed into the same account may become indeterminable. For example, in Florida divorce cases where marital property and non-marital property have been commingled, the non-marital assets can be transformed into marital assets and will be subject to equitable disposition on divorce if the original character of the marital and non-marital assets are not reasonably traceable.[8]

D. The Double Step-up in Basis. The double step-up in basis under Internal Revenue Code §1014(b)(6) allows for a full step-up

5. *Id.* (citing Treas. Reg. § 25-2511-2(b)); Harper v. Commissioner, 6 T.C. 230,238 (1946) (applying California law); Estate of Kelly v. Commissioner, 31 T.C. 493,502 (1958) (applying Louisiana law.)

6. *See generally* William D. Farber, J.D., LL.M, *Transmutation of Separate Property into Community Property*, 37 AM. JUR. Proof of Facts 2d 379 (originally published in 1984).

7. Beyer, *supra* note 2, at 17.

8. Dravis v. Dravis, 170 So. 3d 849 (Fla. Dist. Ct. App. 2015). In *Dravis*, cash gifts that a wife's mother gave to the wife during marriage lost their non-marital character when the gifts were commingled with marital money in a savings account. *Id.*

in basis to fair market value for community property jointly owned by a married couple on the death of one spouse. Under 1014(a), when a person inherits property, the property's tax basis is "stepped up"[9] to its fair market value as of the date of the owner's death.[10] This means that the heir's basis in the inherited property is adjusted to its date of death value, so that any appreciation in value that occurred during the decedent's lifetime is not subject to capital gains tax. Internal Revenue Code §1014(b) lists the seven types of property that are considered to have been acquired from or to have passed from the decedent for purposes of §1014(a). Further, §1014 (b)(6) provides that "property *which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State*, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate," shall be considered to have been acquired from or to have passed from the decedent.

As a result, the surviving spouse receives a stepped-up basis as to their one-half of the community property, and because this half, along with the decedent's half, are considered to have both been acquired from or to have passed from the decedent, both ownership interests in the community property are stepped up to the fair market value on the first spouse's death (assuming at least one-half of the whole of the community interest was includible the decedent's gross estate).[11]

The double step-up in basis is one of the central reasons why a married couple may wish to have their property treated as community property.

3. **Be Careful.** Be very careful when a married couple has or has had community property and has moved to a separate property state. It is safest to confer with a lawyer who practices in the state

9. Or "stepped down" when the fair-market value is less than the original cost of the property.

10. I.R.C. § 1014(a).

11. *See, e.g.,* Holt v. U.S., 39 Fed. Cl. 525, 527 (Fed. Cl. 1997) (providing that "the surviving spouse's one-half interest in community property, even though not actually passing through the decedent's estate, is defined, for basis purposes, as an interest acquired from the decedent). By virtue of this fiction then, the entirety of the community property achieves a step-up in basis-one-half by actual transfer from the decedent (as recognized in 1014(b)(1)); the other half (the surviving spouse's interest) pursuant to the constructive transfer recognized in 1014(b)(6)." *Id.*

where the community property came about or exists and a lawyer who understands how community property functions in the non-community property state that the couple has moved to in order to be sure that nothing is missed.

4. **Step-Up In Basis vs. Creditor Accessibility.** Notwithstanding the advantage of obtaining the step-up on income taxes if one spouse dies, many married couples are more concerned about the possible loss of community property assets to creditors while they are both living. For example, there may be potential exposure of assets to creditors, and a constructive gift made by one spouse when the other spouse transfers assets in his or her name to an irrevocable trust or otherwise, if the assets are community property.[12]

The debtor and creditor laws vary greatly among the community property states, as discussed in depth below.

5. When the Couple Moves to a Non-Community Property State. When a married couple moves from a community property state to Florida there is case law and literature to support the proposition that the community property assets remain as community property assets, if they are not sold or exchanged for other assets, unless and until they are transmuted out of community property status.[13,14] If they are sold or exchanged for other assets then the law is not as clear.

Where a couple that has moved from a community property state to a non-community property state wishes to primarily use a lawyer in the non-community property state, it may work best to keep the community property assets that were acquired in the community property state under a joint trust to ensure identification and to avoid the commingling of such assets. An added benefit of this arrangement is the ability to have the trust assets pass one-half to a new revocable trust established by the first dying spouse and one-half to a separate revocable trust established by the surviving spouse. This permits the lawyer in the non-community property state to use the same general forms and strategies as would normally apply under traditional community

12. *Id*. (stating community property may not be devised by a single spouse and may be "encumbered with debt").

13. A. M. Swarthout, *Annotation, Change of Domicile as Affecting Character of Property Previously Acquired as Separate or Community Property*, 14 A.L.R.3d 404 § 2[a] (originally published in 1967).

14. *See generally* FLA. STAT. §§, 736.1501-736.1512 (2021).

property law, with coordination to allow the joint community property trust to continue and pay into the non-community property trusts on the first death.

Married couples may also agree in a premarital agreement or marital property agreement that the laws of a particular state, including a state other than their domicile, will govern the married couple's rights in property acquired during the marriage.[15]

6. **Florida Case Law.** In the 1967 Florida case of *Quintana v. Ordono*, a husband took community property and sold it in exchange for a note, the note was found not to be community property, but the husband was found to be holding the note one-half as his own property and one-half as his wife's.[16] The wife's equitable interest in the note was considered to be held under a constructive trust for her benefit because it originally came from community property.[17] This case illustrates that in transactions affecting community property in non-community property states, where one spouse buys property in their own name, a resulting trust is generally found to exist in favor of the other spouse. This case further supports the legal position observed in Takeaway #4 above.

7. **Uniform Disposition of Community Property Rights at Death Act (UDCPRDA).** Florida and the below enumerated fifteen states have adopted the Uniform Disposition of Community Property Rights at Death Act,[18] which generally indicates that community property laws are replicated in Florida for inheritance purposes, unless or until community property that is brought to Florida by a former community property couple is transmuted.[19]

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15. RESTATEMENT (SECOND) OF CONFLICT OF L. § 258.

16. Quintana v. Ordono, 195 So. 2d 577, 580 (Fla. Dist. Ct. App. 1967).

17. *Id.* The elements that must be established for a court to impose a constructive trust are: (1) a promise, express or implied, (2) a transfer of property and reliance thereon, (3) a confidential relationship, and (4) unjust enrichment. Gersh v. Cofman, 769 So. 2d 407 (Fla. Dist. Ct. App. 2000). In the context of marital property disputes, constructive trusts are used to enforce the principles of equitable distribution. "Even when a property has not been acquired by fraud, a constructive trust will be imposed if equity would be offended should the property be retained by the person holding it . . . . This is so because a constructive trust is a remedial device with the dual objectives of restoring property to its rightful owner and preventing unjust enrichment . . . .The wife presents a classic case where the imposition of a constructive trust is necessary to do justice and 'prevent the unjust enrichment of one person at the expense of the other." PROPERTY DISPOSITIONS, FACS FL-CLE 6-1, citing Geiser v. Geiser, 693 So. 2d 59 (Fla. Dist. Ct. App. 1997).

18. Conveniently referred to as the "UDCPRDA," which also stands for "Understanding the Disposition of Community Property is Really Difficult and Agitating."

19. FLA. STAT. §§ 732.216-732.228. *See also* Beyer, *supra* note 2, at 22.

The UDCPRDA has also been enacted in Alaska, Arkansas, Colorado, Connecticut, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming.[20]

Dr. Gerry Beyer has observed that "[t]he UDCPRDA is not a tax statute and on its face is limited to the spouse's rights of testamentary disposition over the property."[21] There is no binding federal tax authority known of by the authors that uses the UDCPRDA as support for obtaining the double step-up in basis under Internal Revenue Code §1014(b)(6). However, a 1993 IRS Field Service Advisory, which cannot be cited as authority, acknowledged that the UDCPRDA was enacted to ensure that the surviving spouse would have the same ownership rights in Oregon as she would have had if still domiciled in California.[22] The Advisory, in determining what a surviving spouse's tax basis would be in Oregon real estate purchased with the proceeds of the sale of a couple's California community property residence, found that both halves of the Oregon property were afforded the double step-up in basis on the death of the first spouse.[23]

8. **Trust Planning Constraints**. On the death of one spouse in a community property state, individually owned community property passes one-half through the probate or revocable trust estate of the first dying spouse, and thus pursuant to his or her Last Will and Testament, or intestate succession, while the other half is considered to be owned outright by the surviving spouse, regardless of titling, unless a specific state or federal law applies otherwise [such as Homestead or TBE in Florida].[24]

It is very common in community property states for spouses to form and fund a Joint Trust that declares its assets to be community property, and directs or confirms that on the first death 50% of the Trust assets will be owned directly and immediately by

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20. Beyer, *supra* note 2, at 22.
21. *Id.*
22. *Id.* Field Service Advisories are not binding on the IRS or taxpayers, but often provide good background and an indication of how the IRS or a court might rule under particular circumstances. Field Service Advisories are issued in response to requests from IRS field personnel and are generally requested for purposes of legal guidance with regard to a specific situation of a specific taxpayer. Federal district courts have ruled that the IRS is not bound by field-service advisories and that the IRS need not treat similarly situated taxpayers similarly. Schering-Plough Corp. v. United States, No. 2:05cv-02575 (D. N.J. Dec. 3, 2007).
23. *Id.* (citing 1993 WL 1609164 (1993)).
24. 41 C.J.S. *Husband and Wife* § 383 (2023).

the surviving spouse, and 50% will pass as directed in the Trust to a Credit Shelter Trust to be held for the health, education, maintenance and support of the surviving spouse, subject to possible changes. If the assets so passing, along with other assets, will exceed the first dying spouse's estate tax exemption amount, such assets may pass to the surviving spouse through a marital deduction trust (which will almost always be a "Qualified Terminable Interest Property ("QTIP") Trust"), if facilitated under the Trust documents.[25]

9. **Consider a JEST.** As an alternative to the above, the married couple can transmute out of community property treatment and use separate revocable trusts by balancing assets between the spouses, or they may use a Joint Exempt Step-Up Trust ("JEST Trust") that may replicate the step-up in basis on the first dying spouse's death by use of a Power of Appointment exercisable by the first dying spouse.[26] The JEST offers the possibility of having more than just half of the Trust assets pass to fund a Credit Shelter Trust on the first death.[27] In fact, all of a JEST trust's assets may pass in this way.[28] The IRS has not approved the full step-up in basis but has issued private letter rulings and a Technical Advisory Memorandum ("TAM") (which have been criticized by some) to allow for up to all of the Trust assets to fund a Credit Shelter Trust.[29]

10. **Community Property Trusts.** Alaska, South Dakota, Tennessee, Kentucky, and Florida as of 2021 provide that a married couple living anywhere in the world can establish a Community Property Trust in the applicable jurisdiction by having a Trustee in the applicable state as sole Trustee or Co-Trustee of a specially drafted Community Property Trust.[30]

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25. Richard L. McCandless, *Drafting Marital Deduction Provisions*, 64 DICK. L. REV. 425, 425 (1960) (stating that marital deduction trusts offer tax deductible advantages).

26. Martin M. Shenkman, *Hecklering 2015 Nuggets Grantor Trusts, the Quest for Basis, and More!*, NAEPC J. Est. & Tax Plan., at 40 (2015).

27. *Id.*

28. *Id.*

29. *Joint Ownership, Joint Trusts and Basis-Step-up*, GREENLEAF TRUST (May 24, 2023), https://greenleaftrust.com/missives/joint-ownership-joint-trusts-and-basis-step-up/; I.R.S. Tech. Adv. Mem. 93-08-002 (Feb. 26, 1993); I.R.S. Priv. Ltr. Rul. 200101021 (Jan. 05, 2001); I.R.S. Priv. Ltr. Rul. 200210051 (Mar. 08, 2002); I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004).

30. Michael A. Sneeringer, *An Introduction to Community Property Trusts*, 35 PROB. & PROP. 34 (2021)..

The Community Property Trust assets will be exposed to creditor claims of one or both spouses in differing degrees, depending upon the state chosen, and the step-up in income tax basis for all Community Property Trust assets on the first death can be claimed on income tax returns, although the IRS has not blessed this result, and has specifically indicated in Publication number 555 entitled "Community Property" that was last updated in March 2020 that the IRS is not concluding whether a double step-up occurs by way of an elective community property regime.[31] IRS Publications are not binding on the IRS.[32]

11. **Support for Community Property Trusts.** The Tax Court opinion of *Angerhofer*, described below,[33] supports the proposition that individuals residing in a jurisdiction that allows a couple to decide if they want community property or not, permits the community property to be treated as such for income tax basis step-up planning purposes once the election is made. *Angerhofer* involved a German couple and Germany's choice of characterization rules and can be read to indicate that "if a state incorporates characteristics of community property statutes from the eight original community property jurisdictions in its community property trust legislation, it should be respected by the IRS (or at least by the Tax Court if the IRS challenges a taxpayer's classification of property as community in nature)."[34]

Alaska has a similar law that allows a couple residing in Alaska to elect into the community property regime.[35] Wisconsin law allows couples to elect out of its community property regime.[36] The other community property states and jurisdictions provide

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31. *Publication 555 (03/2020)*, Community Property, IRS (Mar. 27, 2000), https://www.irs.gov/publications/p555#en_US_202001_publink1000264796.

32. 26 C.F.R. § 601.201 and 26 U.S.C. §6110(k)(3). Additionally, in *Bobrow v. C.I.R.*, 107 T.C.M. (CCH) 1110 (Tax 2014), the court emphasized that IRS published guidance is not binding precedent and that taxpayers "rely on IRS guidance at their own peril." *See also* Janet Novack, *`Taxpayers Rely On IRS Guidance At Their Own Peril,' Tax Judge Rules*, FORBES (Apr. 18, 2014), https://www.forbes.com/sites/janetnovack/2014/04/18/taxpayers-rely-on-irs-guidance-at-their-own-peril-tax-judge-rules/?sh=99225502ceab.

33. *See* Angerhofer v. C.I.R., 87 T.C. 814 (1986).

34. Joseph M. Percopo, *Understanding The New Florida Community Property Trust, Part II,* THE FLORIDA BAR (Oct. 2022), https://www.floridabar.org/the-florida-bar-journal/understanding-the-new-florida-community-property-trust-part-ii/#u6e00, quoting Travis Hayes, *To Share and Share Alike: An Examination of the Treatment of Community Property in Florida and the New Florida Community Property Trust Act*, at 28 (unpublished manuscript) (on file with the author). *See Angerhofer* at 827-29. Thank you to Steve Akers and Jonathan Blattmachr for their comments and insight on the Angerhofer decision.

35. Beyer, *supra* note 2, at 13.

36. *Id.* at 11.

that community property jurisdiction is mandatory, but that a couple can "transmute out" of community property status.[37]

12. **<u>Don't Let Your Estate Plan be the Titanic.</u>** There is much more to know, but the above is hopefully a good tip of a somewhat confusing and unstable iceberg.

II. UNDERSTANDING COMMUNITY PROPERTY & COMMUNITY PROPERTY TRUSTS – PRELIMINARY CONSIDERATIONS:

As noted above, Community Property can be defined as assets that are accumulated by one or both members of a married couple who reside in a community property state or jurisdiction, or who have placed such assets under a Community Property Trust if it is situated in a Community Property Trust jurisdiction.[38]

The Community Property Law is based upon the premise that each spouse in a married couple should have equal rights to ownership of property that they jointly acquire or that comes from the earnings of one or both spouses.[39] A central pillar of community property law is that a surviving spouse has the right to receive one half of all community property outright on the first death, with the dying spouse having the right to direct where the other half of the community property will pass.[40] Individual spouses residing in community property states have and receive "separate property" by inheritance, gift, or by reason of ownership before the marriage or before the married couple has moved to a community property state,[41] although, a married couple residing in a community property state may agree to have some or all of their formerly separate or other non-community property become community property.[42]

A primary advantage of community property is that upon the death of the first dying spouse, the surviving spouse will enjoy a

37. Noel Joseph Darce, *Interspousal Contracts*, 42 LA. L. REV. 727, 733 (1982); *see, e.g.*, CA Fam. Code § 850 (2022) (allowing the transmutation of property to change its status from community property to separate property).

38. Beyer, *supra* note 2, at 1.

39. *Id.*

40. *Id.* at 3.

41. *Id.*

42. *Id.*

step-up in basis on both ownership portions of the property.[43] A second advantage is the general fairness between the spouses. By contrast, in a non-community property jurisdiction (also known as a common law jurisdiction) one spouse may die owning significant assets that were earned solely by that spouse during the marriage and also may die owning significant assets accumulated before the marriage or inherited during the marriage.[44] In a common law jurisdiction, the surviving spouse may elect to receive a certain portion of the assets owned by the first dying spouse, commonly 30%, notwithstanding whether the surviving spouse was married to the first dying spouse when the assets were earned or accumulated.[45]

Other aspects of consideration with respect to community property occur when a married couple moves from a community property state to a non-community property state, and whether to transmute the community property assets to non-community property status, or to make efforts to maintain a characterization of community property for income tax basis planning.

Traps for the unwary include the possibility that a spouse is making a taxable gift for federal gift tax purposes when he or she funds a joint revocable trust that does not permit both spouses to separately have the right to terminate the trust, and in situations where a spouse transfers community property to a trust, and this is considered to be a gift made one-half by the other spouse,[46] or where a gift of community property is considered to have not occurred by reason of not having the consent of the other owner spouse.[47]

Effective July 1, 2021, Florida followed a handful of other states by enacting a Community Property Trust Act that allows married couples residing anywhere in the world to “opt-in” to

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43. Richard B. Toolson, *Our Greatest Hits | Community property step-up in basis*, CPA JOURNAL ARCHIVES (Aug. 2017), https://www.cpajournal.com/2017/08/18/greatest-hits-community-property-step-basis/.

44. *See* Kenneth W. Kingma, *Property Division at Divorce or Death for Married Couples Migrating between Common Law and Community Property States,* 35 ACTEC J. 74-96, 75, 84, & 86 (2009) (highlighting the separation of assets upon death in common law states).

45. FLA. STAT. § 732.201.

46. Gerald Treacy, *Community Property: General Considerations,* Portfolio No. 802., BLOOMBERG TAX, https://pro.bloombergtax.com/portfolio/community-property-general-considerations-portfolio-802/ (last visited July 16, 2023).

47. For a good discussion on the tax and nontax implications of actual community property, see Howard M. Zaritsky & Farhad Aghdami, Tax Planning for Family Wealth Transfers at Death 4.06 (Thomson Reuters/WG&L 2014)

community property treatment for assets held in a trust that meets certain requirements.[48] As mentioned above, and described in-depth below, community property can have considerable income tax planning benefits due to Internal Revenue Code Section 1014(b)(6), which provides for all community property assets (including the surviving spouse's interest in community property) to receive a full step-up in basis upon the death of the first dying spouse.[49]

1. Criticisms of and Support for Community Property Trust Legislation

Renowned author and estate tax planning authority, Jonathan Blattmachr, astutely points out two important issues with Florida's Community Property Trust Act. First, the Alaska community property trust law more closely follows traditional community property law than the other community property trust states and therefore may be a safer vehicle to receive a step-up in basis on the death of one spouse.[50] Second, Blattmachr points out that the Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") does not explicitly provide that community property status continues when a couple moves to a non-community property state,[51] but we have found that the case law in the U.S. going back to 1826 does support the proposition that community property remains as such when a couple moves to a non-community property state.[52]

Blattmachr makes two additional points: A mere labeling of assets as community property is not sufficient to make them community property for federal tax purposes.[53] In that regard, *Angerhofer v. Commissioner*, is instructive.[54] The married couple

48. FLA. STAT. §§ 736.1501-736.1512.
49. I.R.C. § 1014(b)(6).
50. Alan Gassman, Jonathan Blattmachr & Brock Exline*, Using the Florida Irrevocable Community Property Trust to Protect an Elderly Couple from Abuse*, STEVE LEIMBERG'S EST. PLAN. EMAIL NEWSL. – ARCHIVE MESSAGE #2914 (NAEPC J. EST & TAX PLAN.), Oct. 14, 2021.
51. Sneeringer, *supra* note 30.
52. Robert Neuner, *Marital Property and the Conflict of Laws*, 5 LA. L. REV., 167, 171 (1943). *See also* A. M. Swarthout, *supra* note 13.
53. Jonathan G. Blattmachr, Howard M. Zaritsky & Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & T.R. J. 615 (1998).
54. Angerhofer v. C.I.R, 87 T.C. 814 (1986). Before changes were made to the Internal Revenue Code in 1984, a non-working spouse who filed separately was entitled to half of his

in *Angerhofer* were German citizens domiciled there and took the position that they lived under a community property regime pursuant to German law, which actually provides that married couples who live there will be subject to one of three different marital property regimes.[55] Unless a German couple agrees otherwise, they basically live under a separate property regime, but they can opt into one of the two other regimes.[56] The Tax Court found that one of those other regimes would be considered to be community property for federal income tax purposes, and the couple in *Angerhofer* ultimately conceded that they had never agreed to opt into the German equivalent of community property status.[57] The Tax Court decision can be read as dicta to indicate that the couple could have opted into the German community property regime and would have had their earnings treated as community property for U.S. federal income tax purposes. But the couple only opted into the regime that did not grant each spouse full community property rights in the view of the Tax Court.[58] The missing key ingredient under the German marital regime the couple opted into was that the first dying spouse would not have been able to bequeath his or her one-half of the marital assets however he or she wished to do so.

Similarly, in *Westerdahl v. Commissioner,* a majority of the Tax Court determined in a full Tax Court Opinion that under Swedish law the married couple's U.S. earnings were community property and that the non-working spouse did not have to pay U.S. income tax on her fifty percent share of such earnings.[59] The Court's decision rested on whether Swedish law gave the non-working spouse a present vested interest in the working spouse's earned income, an attribute that generally applies in community property jurisdictions in the United States. The Court determined that the Swedish law that applied to a married couple residing in Sweden was community property law, because the Swedish law essentially provided that the income of one spouse would be

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or her spouse's income subject to U.S. taxation (because the spouse worked in the U.S. or for an American employer) but was not responsible for paying U.S. income tax on the non-working spouse's half of such income.

55. *Angerhofer*, 87 T.C. at 815.
56. *Id.* at 820.
57. *Id.* at 827.
58. *Id.* at 829-30.
59. Westerdahl v. C.I.R., 82 T.C. 83, 95 (1984).

considered to be one-half earned by the other spouse.[60] The Court concluded that the non-working spouse did have a sufficient present vested interest in one-half of the working spouse's income and therefore deemed the earnings to be community property under the laws of the United States.[61] Because the earnings were treated as community property under the laws of the United States, the working-spouse was entitled to report only one-half of his or her United States earnings on their Federal Income tax returns for the years in issue.

As noted above in Takeaway #11, *Angerhofer* and *Westerdahl* can be read to indicate that if a common law state includes the traditional attributes of community property from the laws of the original community property jurisdictions within its community property trust legislation, it ought to receive recognition from the IRS, or at the very least, from the Tax Court, in the event the IRS disputes a taxpayer's classification of property as community property.[62]

Blattmachr has informed the authors that in drafting the Alaska Community Property Trust statutes he "slavishly" followed the Uniform Community Property Act, which Wisconsin enacted, and which the IRS concluded in Rev. Rul. 87-13 caused Wisconsin residents to have community property for federal tax purposes even though labeled "marital property" rather than "community property," (a label alone will not suffice.)[63] Because Florida does not grant the full panoply of rights and obligations that are normally granted under traditional community property laws,

60. *Id.* at 95. "We have weighed the presence and absence of the various attributes indicative of community property jurisdictions, and we are of the opinion that the laws of Sweden give a spouse a present vested interest in marital property which matures at the time the property is contributed to the marriage by the other spouse." *Id.*

61. *Id.* "Although certain attributes of a spouse's 'giftoratt' (the Swedish concept for marital property) may appear to suggest a deferred interest or claim in marital property rather than a present vested interest, all of these indicia are present in some of the recognized American community property states. We have weighed the presence and absence of the various attributes indicative of community property jurisdictions, and we are of the opinion that the laws of Sweden give a spouse a present vested interest in marital property which matures at the time the property is contributed to the marriage by the other spouse." *Id.*

62. *See* Percopo, *supra* note 34, citing Travis Hayes, *To Share and Share Alike*.

63. WISC. DEPT. OF REVENUE, PUB. 113, FEDERAL AND WISCONSIN INCOME TAX REPORTING UNDER THE MARITAL PROPERTY ACT (Feb. 2023). *See also* Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers at Death 4.07[7][c][i]* (Thomson Reuters/WG&L 2014); Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers During Life § 8:73* (Thomson Reuters/WG&L, 5th ed., repub'd 2023).

Blattmachr reasonably questions whether assets held in a Florida community property trust will qualify under Internal Revenue Code Section 1014(b)(6) to receive a stepped-up income tax basis when the first spouse dies.[64]

While Blattmachr's concerns are important and should be understood by all planners, there are established and respected community property law jurisdictions that are similar to even the most deviant state community property trust statutes. For example, the community property laws in New Mexico, Nevada, Washington, and Wisconsin limit a creditor owed a premarital obligation by one spouse to seize one-half of any community assets, but allow creditors who have claims attributable to actions taken during the marriage to levy upon all community property.[65] Moreover, Texas law distinguishes between "joint management" and "sole management" community property and allows post marital obligations to be satisfied by 100% of "joint management" community property, but only 50% of the nonliable spouse's "sole management" community property.[66] This is further discussed in-depth below.[67]

Additionally, Florida Probate lawyers need to be aware that Florida law will only permit a surviving spouse to successfully assert community property rights against the estate of a deceased spouse if the surviving spouse has filed an appropriate creditor claim within two years of the death of the first dying spouse or within the notice period permitted once a probate has been filed and proper notice has been given, whichever expires first.[68] Thus, Community property rights that flow through a Florida probate state will be lost if a claim is not made in a timely manner after proper notice has been provided.[69,]

64. Gassman, Blattmachr, & Exline, s*upra* note 50.

65. IRM, 25.18.1.3.14 (2023), https://www.irs.gov/irm/part25/irm_25-018-001.

66. *Texas Community Property & Spousal Debt*, BILLS.COM (updated Sep. 20, 2023), https://www.bills.com/learn/debt/texas-community-property.

67. *See infra* section V.

68. Fla. Stat. §§ 733.702(1), 733.710(1); *see Johnson v. Townsend*, 259 So. 3d 851, 853 (Fla. 4th Dist. Ct. App. 2018).

69. Juan C. Atuñez, *A User's Guide to Prosecuting Claims under Florida's Uniform Disposition of Community Property Rights at Death Act*, FLORIDA PROBATE + TRUST LITIGATION BLOG (Aug. 4, 2020), https://www.flprobatelitigation.com/2020/08/articles/new-probate-cases/marital-agreements-and-spousal/a-users-guide-to-prosecuting-claims-under-floridas-uniform-disposition-of-community-property-rights-at-death-act/; *see also* Johnson v. Townsend, 259 So. 3d 851(Fla. Dist. Ct. App. 2018). In general, a Florida probate estate creditor has three months after receiving formal notice, or 2 years if no notice is given, to file claims against the estate. F.S. §733.702; §733.710. *See also* Gassman, Exline, & Farrell,

2. A Brief History of Community Property and Community Property Trust Legislation

Some of the key information regarding this community property review has been derived from an excellent article written by Steve R. Akers as part of his ACTEC 2013 Fall Meeting Musings, which can be found online.[70]

What is Community Property?

There are two primary types of legal regimes for property ownership for married couples — community property law states and common law states (also known as separate property states or non-community property states). Under a community property system, all property of the spouses is considered to be either "community" or "separate" property. In all community property states, except California, all property acquired during the marriage is generally presumed to be community property unless clear and convincing evidence demonstrates that the property is the separate property of one spouse only. In California, a preponderance of the evidence standard applies for proving the nature and extent of separate property of one spouse.[71] Property received by one spouse as a gift or inheritance as his or her "sole and separate property" generally becomes the sole and separate property of that spouse, unless affirmative steps are taken to characterize the property as community property.[72]

In the U.S., there have historically been eight community property states and two territories that have applied community property law: Arizona, California, Idaho, New Mexico, Louisiana, Texas, Nevada, Washington (state), Guam, and Puerto Rico.[73] The community property laws in these states generally evolved from Spanish law, except that Louisiana's community property law came from French law.[74] Wisconsin and Alaska became community

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Designing Trust Systems For Florida Residents: Planning Strategies, Things You Should Know, and Traps for the Unwary, Vol. 97, No.4, July/Aug 2023, 28.

70. Steve R. Akers, *ACTEC 2013 Fall Meeting Musings* (Nov. 2013), https://www.naepcjournal.org/journal/issue16d.pdf.

71. *In re* Marriage of Ettefagh, 150 Cal.App.4th 1578, 1591 (Cal. Ct. App. 2007).

72. Akers, *supra* note 70, at 3.

73. *Community Property States vs. Common* Law, ASSET PROTECTION PLANNERS. https://assetprotectionplanners.com/planning/community-property-states/.

74. Paul H. Dué, *Origin and Historical Development of the Community Property System*, 25 LA. L. REV. 78, 90 (1964).

players in 1986 and 1998, respectively, and their community property regimes are discussed below.[75]

Wisconsin became the ninth community property state in 1986 when it became the first state to adopt the Uniform Marital Property Act.[76] The Uniform Marital Property Act is a community property system developed by the National Conference of Commissioners on Uniform State Laws. In 1998, Alaska also enacted the Uniform Marital Property Act[77]on an elective basis so that couples who reside in Alaska have the choice of having the community property law apply or not apply without the need to form a community property trust.

While the nine community property states discussed above are all considered "community property states," there are numerous differences among the laws of the community property states. Exhibit 25.18.1-1 of the IRS Manual details many of these differences.[78] As noted by Steve Akers, Oklahoma and Oregon had opt-in community property systems briefly in the late 1930s and 1940s, but quickly repealed them less than a year after enactment of the Revenue Act of 1948, as further discussed below.[79,80]

There is great variation amongst the laws of the traditional eight community property states with regard to creditor laws, property characterization and more. For example, California,

75. William G. More, *Community Property Comes to Wisconsin*, UNIV. OF WIS. LAW SCH. 9, https://media.law.wisc.edu/s/c_420/gyn2c/gargoyle_16_2_4.pdf; Thomas M. Featherston, Jr., *Separate Property or Community Property: An Introduction to Marital Property Law in the Community Property States*, BAYLOR UNIV. 1, 2 (2017).

76. *See* Kathy T. Graham, *The Uniform Marital Property Act: A Solution for Common Law Property Systems?*, 48 S. D. L. REV. 455, 458 (2003).

77. *See* Erica K. Smith, *Basic Estate Planning in Florida Chapter 14: Community Property Issue*s, THE FLORIDA BAR 11TH ED. 3 (2022).

78. I.R.S.*, Community Property* (2017).

79. Akers, *supra* note 70, at 3.

80. *See* Jennifer E. Sturiale*, The Passage of Community Property Laws, 1939-1947: Was "More Than Money" Involved?*, 11 MICH. J. GENDER & L. 213 (2005) (observing that "[i]n response to the disparate treatment of taxpayers that resulted from *Earl* and *Seaborn*, a flurry of states adopted community property statutes between 1939 and 1947 – Michigan, Nebraska, Oklahoma, Oregon, and Pennsylvania. Eight states – Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington – already had community property laws in place. Before other states could similarly adopt community property statutes, Congress responded with the Revenue Act of 1948, which stated, in pertinent part, '[e]equalization is provided for the tax burden of married couples in common-law and community property states.' . . . In less than a year after the adoption of the Revenue Act of 1948, Michigan, Nebraska, Oklahoma, and Oregon repealed their community property statutes. Pennsylvania may have, as well, had the Pennsylvania Supreme Court not already found its state's community property laws unconstitutional."); *Id.* at 215–16 (citations omitted).

Arizona, New Mexico, Nevada, and Washington treat income from separate property as separate property, while Idaho, Texas, Louisiana, and Wisconsin treat income from separate property as community property.[81] These state by state variations are discussed in depth-below and underscore the importance of working with an experienced practitioner in the state where the community property originated.

In most community property states, couples can simply enter into matrimonial agreements during marriage (without petitioning a court) that modify or terminate ("transmute") their community property characterization of assets, although they may be required to record such agreements in the public records to transmute real estate.[82]

Alaska adopted an innovative "opt-in" community property trust law in 1998,[83] which is described below; Tennessee,[84] South Dakota,[85] and Kentucky[86] also adopted "opt-in" community property systems in 2010, 2016, and 2020, respectively. The Kentucky and Tennessee statutes are very similar.

Alaska's Community Property Act, which was enacted under the leadership of Blattmachr, provides that non-Alaskans can hold assets in Alaska community property trusts, with the expectation that all assets of the trust will receive a step-up in income tax basis upon the death of the first dying spouse.[87] While Alaska also has a strong Asset Protection Trust law, assets placed in an Alaska community property trust will not be protected from the creditors of the married couple, and in effect, creditors of one spouse can reach all assets held under an Alaskan community property trust, as further discussed below.[88]

81. Beyer, *supra* note 2 at 2.

82. IRM, *supra* note 65 at 25.

83. *See* Shelly D. Merritt, *Planning for Community Property in Colorado*, COLO. LAW. 79, 85 (2002).

84. *See* J. Paul Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 UNIV. OF MEMPHIS L. REV. 369, 378 (2011).

85. *See* A1 W. King III & Pierce H. McDowell III, *A Bellwether of Modern Trust Concepts: A Historical Review of South Dakota's Powerful Trust Laws*, 62 S. D. L. REV. 266, 299 (2017).

86. *See* Zaritsky, *Tax Planning for Family Wealth Transfers at Death: Analysis with Forms*, THOMSON REUTERS TAX AND ACCOUNTING 52 (2021).

87. Blattmachr et al., *supra* note 53, at 631.

88. ALASKA STAT. § 34.77.070 (2023).

Likewise, the Tennessee Community Property Trust Act that was enacted in 2010 allows for non-Tennessee residents to hold assets in community property trusts.[89] Under the Tennessee community property trust law, the obligation of one spouse incurred before or during the marriage can be satisfied only from that spouse's one-half of the trust.[90] On a spouse's death, half of the value of the trust becomes the deceased spouse's share and the other half becomes the surviving spouse's share.[91] The provisions of Tennessee's Community Property Trust Act are similar to Florida's new rules, which are discussed below.

In 2016, the South Dakota Legislature passed a law authorizing the creation of a South Dakota Special Spousal Trust which permits the use of a trust to opt in to a community property system.[92] Interestingly, a South Dakota Special Spousal Trust can also be established as a self-settled spendthrift trust, which is referred to under South Dakota law as a qualified disposition in trust.[93]

In March 2020, Kentucky followed suit and enacted their own community property trust legislation which allows non-resident married couples to place assets into community property trusts.[94] While the Alaska, Tennessee, South Dakota, and Kentucky Acts seek to provide non-residents with the ability to "opt-in" to the advantages of community property,[95] commentators have voiced concerns about whether assets in such trusts will be afforded the "double" tax free step up in basis upon the death of the first spouse, while pointing out that creating such trusts can potentially forfeit valuable creditor protection benefits.[96]

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89. TENN. CODE ANN. § 35-17-105 (2023).

90. TENN. CODE ANN. § 35-17-106(a) (2023). For an additional discussion on Tennessee Community Property Trusts see Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers at Death*, THOMSON REUTERS/WG&L 4.07[7][c][ii] (2014) and Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers During Life* § 8:74 (Thomson Reuters/WG&L, 5th ed., repub'd 2023).

91. TENN. CODE ANN. § 35-17-107 (2023).

92. S.D. Codified Laws § 55-17-3. *See also* Zaritsky, *Tax Planning for Family Wealth Transfers at Death*, 4.07; *The Joint Revocable Trust*, WGL-TPFWTD ¶ 4.07[7][c][iii].

93. Zaritsky, *Tax Planning for Family Wealth Transfers at Death*, 4.07[7][c][iii].

94. KY. REV. STAT. ANN. §§ 386.620 –386.624 (2023). *See also* Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers at Death* 4.07[7][iv] (THOMSON REUTERS/WG&L 2014); Howard M. Zaritsky & Farhad Aghdami, *Tax Planning for Family Wealth Transfers During Life* § 8:76 (THOMSON REUTERS/WG&L, 5th ed., repub'd 2023).

95. ALASKA STAT. § 34.77.100 (2023); S.D. CODIFIED LAWS §§ 55-17-5, 55-17-1, 55-17-3 (2023); TENN. CODE ANN. § 35-17-103 (2023); KY. REV. STAT. ANN. § 386.622(1) (2023).

96. *See, e.g.*, Paul Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 U. MEM. L. REV. 369 (2011);

Effective July 1, 2021, Florida joined the ranks of the "opt-in" community property trust jurisdictions by enacting the Florida Community Property Trust Act[97], which is described in more detail below.

The following chart may be of use to readers as they review the remainder of this article:

3. Married Couples Trust Decision Chart

	Step-Up in Basis after First Death	**Creditors of One Spouse Can Reach Trust Assets**	**Can Create Credit Shelter Trust with More Than Half of the Trust Assets**	**May Share Upon Divorce as Set Forth in Pre- or Post-Nuptial Agreement**	**May Be Converted from Former Joint or Individual Trust**	**Complex to Draft?**	**Requires Qualified Trustee**
JEST (Joint Exempt Step-Up Trust)	Probably Yes	Yes – the Debtor Spouse's Share	Yes, All Trust Assets May Go Into Credit Shelter Trusts	Yes	Yes	Yes	No
Tenants by the Entireties Trust	Only Half of a Step-Up	Protected from Either Spouse's Creditors	Up to Half, But Only by Disclaimer or Surviving Spouse Will Not Have a Power of Appointment	Probably Not	Yes	Simpler than Jest	No
Joint Trust – Not TBE, JEST, or CPT	Depends Upon Drafting and Logistics	Depends Upon Trust Drafting	Depends Upon Drafting – Be Careful!	Yes	N/A	Will Depend Upon Specifics	No
Florida Community Property Trust	Probably Yes	One-Half of Trust Assets Exposed to One	Only as to One-Half	Yes – Spouses can agree on the	No – Must Be Created On or After July 1, 2021 as a	Simple to Draft if the Statute is Followed	Requires a Florida Trustee

Sneeringer, *supra* note 30; Willaim Chad Roberts, *Feature Story: A Cautionary Tale: Community Property Trusts*, 47 TENN. B. J. 24 (2011).

97. FLA. STAT. §§ 736.1501 – 736.1512 (2023).

		Spouse's Creditors		dissolution of property	new Florida Community Property Trust		
Tennessee Community Property Trust	Probably Yes	One-Half of Trust Assets Exposed to One Spouse's Creditors	Only as to One-Half	Yes – Spouses can agree on the dissolution of property	N/A	Simple to Draft if the Statute is Followed	Requires a Tennessee Trustee
South Dakota Community Property Trust	Probably Yes	All of Trust Assets Exposed to One Spouse's Creditors	Only as to One-Half	Yes – Spouses can agree on the dissolution of property	Yes	Simple to Draft if the Statute is Followed	Requires a South Dakota Trustee
Alaska Community Property Trust	Probably Yes	All of Trust Assets Exposed to One Spouse's Creditors	Only as to One-Half	Yes – Spouses can agree on the dissolution of property	Yes	Simple to Draft if the Statute is Followed	Requires an Alaska Trustee
Kentucky Community Property Trust	Probably Yes	One-Half of Trust Assets Exposed to One Spouse's Creditors	Only as to One-Half	Yes – Spouses can agree on the dissolution of property	Yes	Simple to Draft if the Statute is Followed	Requires a Kentucky Trustee

III. THE COMPLEXITIES OF ESTATE PLANNING WITH COMMUNITY PROPERTY

1. Joint Revocable Trusts in Community Property

Joint revocable trusts have been the most popular trust instrument for married couples in community property states and can be used in the "opt-in" community property jurisdictions.[98]

98. For an additional discussion on Joint Community Property Revocable Trusts in non-community property states see HOWARD M. ZARITSKY & FARHAD AGHDAMI, TAX PLANNING FOR FAMILY WEALTH TRANSFERS AT DEATH 4.07[5], 4.07[7] (Thomson Reuters/WG&L 2014)

Community property contributed to a joint revocable trust will be treated as community property for federal tax purposes under Internal Revenue Code Section 1014(b)(6) as long as it is considered community property under state law.[99]

The language of Internal Revenue Code Section 1014(b)(6) permits a full step-up in income tax basis for all community property of the death of one spouse, and reads as follows:

"**(6)** In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;"[100]

The double step-up in basis under Internal Revenue Code Section 1014(b)(6) does not apply to quasi-community property or to property held as joint tenants with right of survivorship acquired after 1977.[101]

Assigning community property to a revocable trust is unlikely to change its character. For example, in *Katz v. US*, the assignment of a husband and wife's community property to the husband's revocable trust did not convert the property to the separate property of the husband.[102] There, the court held that the statutory presumption under California law that property acquired by spouses during marriage is community property was not overcome by the assignment of the community property to the revocable trust.[103]

The obvious allure of a community property trust is the ability to receive a full step-up in basis on the death of the first dying

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and HOWARD M. ZARITSKY & FARHAD AGHDAMI, TAX PLANNING FOR FAMILY WEALTH TRANSFERS DURING LIFE §§ 8:70 - 8:77 (Thomson Reuters/WG&L, 5th ed. 2013).

99. Rev. Rul. 66-283, 1966-2 C.B. 297 (explaining that "[f]or purposes of section 1014(b)(6) of the Code, H and W are considered as continuing to own the property transferred by them to the revocable trust as their community property.").

100. I.R.C § 1014(b)(6).

101. Gerry Beyer, Tex. Tech Univ. Sch. of L., Session 12A: Community Property Tips and Traps for Lawyers in Common Law States: Strategies for Migrating Clients at the 47th Annual Notre Dame Tax & Estate Planning Institute (Oct. 22, 2021).

102. Katz v. United States, 382 F.2d 723, 728 (9th Cir. 1967).

103. *Id.*

spouse under Internal Revenue Code Section 1014(b)(6), which provides that assets owned as community property will receive a new income tax basis equal to their fair market value on the death of the first dying spouse.[104] This "step-up" in basis applies to the full extent of all community property assets, and not just to the first dying spouse's interest in community property, regardless of whether only one-half of the value of the community property assets are included in the first dying spouse's gross estate for federal estate tax purposes.[105]

In other words, the surviving spouse will receive a step-up in basis for his or her interest in community property *even though* his or her interest is not subject to the federal estate tax system on the first dying spouse's death. This is an incredible advantage provided for community property owners in the Internal Revenue Code, since for federal estate tax purposes the first dying spouse's gross estate typically will include his or her separate property *and* his or her one-half interest in the community property.[106]

Conversely, assets owned jointly by spouses in a manner other than as community property (such as tenants by the entirety, joint tenants with right of survivorship, or tenants in common), where one half of the value of such assets is included in the estate of the first dying spouse for federal estate tax purposes, will receive a step-up in income tax basis only to the extent of the first dying spouse's interest on his or her death (i.e., 50% of assets held in this fashion, unless Internal Revenue Code Section 2036 applies).[107]

The IRS has not confirmed whether a step-up in basis applicable to community property under Internal Revenue Code Section 1014(b)(6) will apply to property held under an elective community property trust system. IRS Publication 555 entitled "Community Property" specifically provides that it "does not address the federal tax treatment of income or property subject to the 'community property' election under Alaska, Tennessee, and

104. Graham, *supra* note 76.
105. 1 AM. JUR. LEGAL FORMS 2D - FEDERAL TAX GUIDE TO LEGAL FORMS § 1:57 (2d. ed. 2023); I.R.C. § 1014(b)(6).
106. 34A AM. JUR. 2D *Federal Taxation* ¶¶ 143,101 & 143,182 (2023).
107. MYRON KOVE ET AL., BOGERT'S THE LAW OF TRUSTS AND TRUSTEES § 273.30 (2022); I.R.C. § 2036 (an asset transferred by an individual before death may be considered to be earned by the individual per federal estate tax purposes if the individual retained the right (1) to possession or enjoyment of or the right to income from the property, or (2) or the right, alone or with another, to designate the persons who shall possess or enjoy or receive income from the property).

South Dakota state laws."[108] This language creates some doubt as to whether the IRS will respect an "opt-in" community property trust for the purposes of affording a full step-up in basis to the assets of the trust on the death of the first dying spouse. Further, commentators have expressed concerns about whether the full fair market value basis step-up will be recognized by the IRS, while pointing out that such trusts will often expose assets to creditors that would otherwise would not have had the ability to reach such assets.[109]

Jonathan Blattmachr believes that the position set forth in the above referenced IRS publication is probably incorrect.[110] He indicates that most of the lawyers in the eight original community property states have most of their married clients transmute their former separate property into community property to secure the "double" step up in basis under Internal Revenue Code Section 1014(b)(6) for their former separate property.[111] He also points out that the Tax Court opinion in *Angerhofer*, which is described under the executive summary of this article, provides support for the proposition that a German couple can opt into the German law community property regime to enable them to be considered to have full community property rights and treatment for federal tax purposes.[112] He also recommends that interested advisors read the article entitled "Tax Planning With Consensual Community Property: Alaska's New Community Property Law," which was written by Howard Zaritsky, Mark Ascher and Jonathan Blattmachr. The article discusses the Supreme Court's treatment of Oklahoma's opt-in community property legislation in the *Harmon* case and the further developments that occurred thereafter.[113] They concluded that opt-in community property, unless it constitutes an anticipatory assignment of income (as the Supreme Court so found in *Harmon*), is just as much community

108. INTERNAL REVENUE SERV., PUBLICATION 555, COMMUNITY PROPERTY (Rev. March 2020).

109. *See* DAVID WESTFALL & GEORGE P. MAIR, ESTATE PLANNING LAW AND TAXATION § 4.03 (2023) ("That the Alaska Community Property Act and the Tennessee Community Property Trust Act of 2010 apply only when spouses elect their application creates uncertainty as to whether income from property governed by these acts will be treated as income from community property for federal income tax purposes . . . ."); *see also* Roberts, *supra* note 96.

110. *See* INTERNAL REVENUE SERV., *supra* note 108.

111. I.R.C. § 1014(b)(6).

112. *See* Angerhofer v. Comm'r, 87 T.C. 814, 828 (1986).

113. Blattmachr et al., *supra* note 53, at 625–31.

property as it would be in a state (such as California) which has an opt in system only for what had been separate property and otherwise treats most assets acquired during the marriage as community property.[114]

2. Survivorship Rights in Community Property & The Uniform Disposition of Community Property Rights at Death Act

Generally, the first dying spouse's interest in community property (and such spouse's interest in separate property) can pass upon his or her death as he or she designates by will or trust while the surviving spouse's interest in community property will become the sole and exclusive property of the surviving spouse.

Sixteen states,[115] including Florida, have adopted the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA). The UDCPRDA provides that community property acquired in a community property jurisdiction while a married couple resides there will be treated in a manner similar to what applies to community property under the testamentary disposition laws of the community property state as the result of the death of the first dying spouse when the couple has moved to a community property jurisdiction.[116]

In other words, the UDCPRDA does not explicitly indicate that the property will continue to be treated as community property, although such a result seems to occur in most, if not all, of the common law states.[117]

The UDCPRDA instead provides that upon the death of one spouse, the one-half of the assets that are community property will pass through probate based upon the testamentary instructions of the first dying spouse, and that the other half will pass directly to, or be completely controlled by, the surviving spouse; and the elective share, dower, courtesy, forced inheritance, or other such spousal share that typically apply in a non-community property

114. *Id.* at 629–31.

115. These 16 states are as follows: Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming. Nebraska legislators have recently introduced a bill that would make them the 17th state to adopt the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA). *Community Property Disposition at Death Act*, UNIF. L. COMM'N, https://www.uniformlaws.org/committees/community-home?CommunityKey=425b0732-7ff0-4b28-ada1-fc2b4638f29e (last visited July 17, 2023).

116. UNIF. CMNTY. PROP. DISPOSITION AT DEATH ACT § 6 (UNIF. L. COMM'N 2021).

117. *Id.*

state will have no impact upon disposition of community property.[118] As the result of this, individuals who move from a community property state to one of the states that do not recognize community property may be well advised to establish and fund a community property trust before making the move, in order to make it more likely that the IRS will respect the community property status of such assets for income tax basis step-up purposes.

Despite the above mentioned reservations about the UDCPRDA and its effect, commentators have noted that states that have embraced the UDCPRDA should be more inclined to acknowledge the characteristics of transitory community property on the death of the first spouse than states that have not adopted the UDCPRDA.[119]

It is worth noting that the Uniform Law Commission's description of the Community Property Disposition at Death Act on their website as of the date of publication reads as follows:

> Community property acquired by a married couple retains its character as community property even when the couple relocates to reside in a non-community property state. This result creates potential distribution problems at the death of the first spouse and also creates potential estate planning opportunities. However, a probate court or trustee in a non-community property state may not recognize the character of community property in a decedent's estate, which could lead to misallocation of the decedent's property, and potentially to disputes between a surviving spouse and the decedent's other heirs. This act is an update of a 1971 act that applied only to probate proceeds. The [Act] also addresses non-probate transfers of community property and provides clear default rules to ensure the proper disposition of community property from any estate, in any jurisdiction. It is recommended for adoption by all non-community property states.[120]

The 1967 Florida Third District Court of Appeals case of *Quintana v. Ordono*[121] is a good example of how these rules work. The case involved a husband and wife who moved from Cuba to

118. Zaritsky, *supra* note 93.
119. Beyer, *supra* note 2, at 22; M. Read Moore & Nicole M. Pearl, *Coming Soon to Your State: Community Property*, Presentation at ACTEC 2020 Fall Meeting (October 27, 2020).
120. *Community Property Disposition at Death Act*, *supra* note 117.
121. Quintana v. Ordono, 195 So. 2d 577 (Fla. Dist. Ct. App. 1967).

Florida in 1960 when Cuba was a community property country.[122] While the couple was residing in Cuba, the husband purchased stock in U.S. companies, which the court found to be community property.[123] After the couple moved to Florida, the husband sold the stock for an $810,000 promissory note, and then died intestate.[124] The children filed an action for a declaratory judgment determining the respective rights of the children and the widow in the note.[125] The court held that the law of the couple's domicile at the time of the acquisition of the property is the law which determines the property interests.[126] Therefore, under the laws of Cuba, the wife had a vested interest in the stock equal to that of her husband.[127] However, because the stock was sold in exchange for the promissory note while the couple were domiciled in Florida, the promissory note was controlled by Florida law and was therefore not community property.[128] The court ultimately applied an equitable remedy, concluding that half of the note, or its proceeds were to be held in a resulting trust for the wife, stating as follows:

> Under Florida law, if a portion of the consideration belongs to the wife and title is taken in the husband's name alone, a resulting trust arises in her favor by implication of law to the extent that consideration furnished by her is used . . . [t]herefore, while the husband held legal title to the note and contract, he held a one-half interest in trust for his wife.[129]

Commentators and practitioners often misconstrue the *Quintana* opinion to mean that property owned by a spouse in Florida will be considered community property if it has its origins in community property, but the court did not determine that the note, or its proceeds, constituted community property under Florida law.[130]

Quintana is the seminal case for this situation in Florida. Court decisions in other common law states have been relatively

122. *Id.* at 578.
123. *Id.* at 579–80.
124. *Id.* at 578–79.
125. *Id.* at 578.
126. *Id.* at 579–80.
127. *Id.* at 580.
128. *Id.*
129. *Id.*
130. *Id.*

uniform on this front, typically trying to respect the community property nature of monies used to purchase real property in the noncommunity property state. They often find that the spouses held the property as tenants in common or apply the equitable remedy of a resulting trust.[131] However, courts in community property states have occasionally held that real property in a common law state is community property, flying in the face of the "lex situs" principle discussed below.[132] For instance, in the case of *Tomaier v. Tomaier*, the California Supreme Court ruled that Missouri real property owned by a married couple domiciled in California should be considered community property. As a result, the court directed the husband to transfer an interest in the property to his wife. The court justified its decision by citing the notion that, according to general conflict of laws principles, a Missouri court would acknowledge that both the husband and wife would be considered to have equally contributed to the property's purchase price when the consideration for the purchase of the Missouri real property was community funds from California.[133]

The Florida UDCPRDA was enacted in 1992 and largely follows the Uniform Act in providing as follows:

> Upon the death of a married person, one-half of the property to which [the Act] appl[ies] is the property of the surviving spouse and is not subject to testamentary disposition by the decedent or distribution under the laws of succession of this state. One-half of that property is the property of the decedent and is subject to testamentary disposition or distribution under the laws of succession of this state. The decedent's one-half of that property is not in the elective [share] estate.[134]

Florida Statute Section 732.224 is derived from the UDCPRDA and provides that the provisions of the Act do not "affect rights of creditors with respect to property to which [the

131. Beyer, *supra* note 2, citing Rozan v. Rozan, 129 N.W.2d 694 (N.D. 1964) (North Dakota mineral rights purchased with community property was treated as owned by the spouse as equal tenants in common under a resulting trust theory); Stone v. Sample, 62 So. 2d 307 (Miss. 1953) (finding that the proceeds from the sale of real property in Mississippi that had been purchased by a married couple who lived in Louisiana was owned equally by the spouses).

132. *Id.*

133. Tomaier v. Tomaier, 146 P.2d 905 (Cal. 1944).

134. FLA. STAT. § 732.219 (2022). Florida's UDCPRDA is codified in FLA. STAT. §§ 732.216 – 732.228.

Act] appl[ies]."[135] This means that there is no change to creditors' rights in community property when a married couple moves to Florida. For example, moving community property from California (a community property state) will not alter a California creditor's rights to pursue such assets, unless or until the couple transmutes the property treatment.

Florida Statute Section 732.225 permits married couples to sever or alter their interests in property by transmuting out of community property status, and specifically provides that the acquisition of Florida property that becomes the couple's homestead creates a "conclusive presumption that the spouses have agreed to terminate the community property attribute of the property reinvested."[136] Florida Statute Section 732.226 provides that the Act does not "authorize a person to dispose of property by will if it is held under limitations imposed by the law preventing testamentary dispositions by that person." The homestead presumption above is one such limitation.[137]

Property held in tenancy by the entirety and property maintained as homestead is explicitly carved out of Florida's UDCPRDA in Florida Statute Section 732.218(2).[138] As attorney and author Juan Antuñez notes, the section is "a poorly drafted and logically confusing amendment to the Uniform Act which states that certain real property is presumed not to be community property, but <u>not</u> homestead and TBE property."[139] Additionally, attorney Richard Warner has stated that Section 732.218(2) "is a blatant double negative and hence that section cannot be used for the support of anything."[140]

Some states have legislation that allows community property to be held with right of survivorship, and the IRS recognized in

135. FLA. STAT. § 732.224 (2022).

136. FLA. STAT. § 732.225 (2022).

137. FLA. STAT. § 732.226 (2022).

138. FLA. STAT. § 732.218(2) (2022) ("Real property located in this state, *other than* homestead and property held as tenants by the entirety, . . . [is] presumed to be property to which these sections *do not* apply." (emphasis added)).

139. Juan C. Antunez, *A User's Guide to Prosecuting Claims under Florida's Uniform Disposition of Community Property Rights at Death Act*, FL. PROB. TRUST LITIG. BLOG (Aug. 4, 2020), https://www.flprobatelitigation.com/2020/08/articles/new-probate-cases/marital-agreements-and-spousal/a-users-guide-to-prosecuting-claims-under-floridas-uniform-disposition-of-community-property-rights-at-death-act/.

140. Richard M. Warner, *Florida Community Property Rights Simplified, 38th Annual Attorney Trust Officer Conference*, THE FLORIDA BAR, Course No. 3241R, at 3.17 (Aug. 23, 2019), https://www.rpptl.org/uploads/VOLUME1revised.pdf.

Revenue Ruling 87–98 that community property could still be treated as community property for tax purposes even though it has a right of survivorship component.[141] For example, community property normally passes one-half directly to the surviving spouse on the first spouse's death by operation of law.[142] Property owned in this manner will be treated as community property for step-up in basis purposes under Internal Revenue Code Section 1014(b)(6).[143]

IV. DEALING WITH TRANSITORY COUPLES, TRANSMUTING AND IMPORTING COMMUNITY PROPERTY AND CHOICE OF LAW CONSIDERATIONS

When a married couple leaves a community property state and moves to a non-community property state, a great many authorities have indicated that the community property retains its character as community property,[144] unless the married couple transmutes out of community property characterization or places the community property into tenancy by the entirety or homestead in states like Florida, which have laws which provide that TBE and homestead property will no longer be considered to be community property.[145]

It was of great surprise to the authors that the Florida and other UDCPRDA(s) do not specifically say that the property retains its character as community property, but instead indicates that the property is distributed on death as if it was community

141. Rev. Rul. 87–98, 1987–2 C.B. 206 ("If property held in a common law estate is community property under state law, it is community property for purposes of section 1014(b)(6) of the Code, regardless of the form in which title was taken.").

142. FLA. STAT. § 736.1507 (2021).

143. *See* Rev. Rul. 87–98, *supra* note 141.

144. A. M. Swarthout, *supra* note 13.

145. *Id.* But the question Jonathan poses is: community property under the law of what state, territory, or country? If assets that were community property, say under Arizona law, which belonged to a couple that moves to Florida, is it realistic to think that the Florida courts will administer the property as community property under Arizona law? It cannot administer the property under Florida community property law as Florida has none (except as to its community property trust law which, would not apply to property brought to the state by the couple, unless, put into a proper community property trust.) If one thinks the Florida courts would administer the property as community property under the laws of the couple's former domicile, doesn't that mean that separate property brought to Florida would have to be administered under the law of the couple's prior domicile? This seems doubtful and if it remains, for example, community property under Arizona law, even though the couple has moved to Florida, then why would the legislature have seen the need to enact the Uniform Disposition of Community Property at Death Act (UDCPRDA)?

property, without even using the words "community property" in the section that talks about the inheritance.[146]

1. Choice of Law Principles

While community property is not known to the common law,[147] common law choice-of-law principles, such as the "partial-mutability" doctrine,[148] and the "lex situs rule,"[149] have been applied when adjudicating the disposition of property disputes where the spouses have not executed an effective choice of law provision by valid agreement.

A. The Partial-Mutability Doctrine

The partial-mutability doctrine essentially provides that the law of the individual or couple's domicile at the time of the acquisition of property governs the interests in movable assets such as personal property.[150] In *Quintana v. Ordono,*[151] described above, without explicitly using the term, Florida's Third District Court of Appeals adopted the partial mutability choice-of-law rule for testamentary property rights of married couples with imported moveable property from a community property jurisdiction.[152] The court stated, "by the almost unanimous authority in America, 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.'"[153]

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146. *See, e.g.*, FLA. STAT. § 732.219 (2023).

147. A. M. Swarthout, s*upra* note 13, at § 2[a] (stating "[T]he community property statutes of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington are drawn from the Spanish, Mexican, or French law. Community property is not known to the common law. In the United States community property derives its existence from express legislation. . . .").

148. Jeffrey Schoenblum, *U.S. Conflict of Laws Involving International Estates and Marital Property: A Critical Analysis of Estate of Charania v. Shulman*, 103 IOWA L. REV. 2119, 2121 (2018). (Stating, "For nearly 200 years, the prevailing doctrine in the United States has been 'partial mutability.'"); *see also* Philip E. Henderson, *Conflict of Laws - rules on Marital Property,* 18 LA. L. REV. 557, 561 (1958).

149. Beyer, *supra* note 2*,* at 15.

150. Schoenblum, *supra* note 148; *Personal Property*, BLACK'S LAW DICTIONARY, 2nd Ed. Personal Property is defined as "[t]he belongings of an individual, excluding any real estate property or other buildings. Generally includes tangible and intangible assets of an individual."

151. Quintana v. Ordono, 195 So. 2d 577 (Fla. Dist. Ct. App. 1967).

152. Antunez, *supra* note 139, at 4–5.

153. *Quintana,* 195 So. 2d at 579.

Jeffrey Schoenblum defines the partial mutability doctrine as follows:

> Under this conflict-of-laws rule, the right of a spouse in a movable asset[154] acquired during marriage is determined by the law of the state in which the spouses had their marital domicile at the time of the acquisition of the asset. Thus, if the spouses change their marital domicile during the marriage, it is entirely possible that different movable assets will be governed by different laws. This conflict-of-laws rule is widely known as 'partial mutability' because the law of the original marital domicile does not remain the governing law as to assets acquired after a change in marital domicile has taken place. In other words, there is 'mutability.' However, it is only 'partial' because with respect to rights acquired at a particular marital domicile, they are not mutable and are not lost simply by moving to a new marital domicile that does not recognize those spousal rights.[155]

B. The Lex Situs Rule

The Lex Situs rule, which primarily applies to real estate provides that such property is governed by the law of the jurisdiction where the property is physically located.[156] In other words, the laws of the place where the property is situated, also known as the "situs" apply. However, Dr. Gerry W. Beyer observes that "[t]he effect of the 'lex situs' rule followed by U.S states is that the characterization of real property acquired in a community property jurisdiction during marriage will depend on the source of the funds used to purchase the property."[157]

New Mexico Community Property Law Applied When a Texas Couple Owned New Mexico Property. In the New Mexico Supreme Court case of *In re Clarke's Will*,[158] the Court determined that New Mexico law, and not Texas law, would apply to resolve the question of whether the income earned on real estate purchased in New

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154. Movable assets generally refer to personal property such as cars, furniture, jewelry, etc. *See, e.g.,* Alena Geffner-Mihlsten, *Lost in Translation: The Failure of the Interstate Divorce System to Adequately Address the Needs of International Divorcing Couples*, 21 S. CAL. INTERDISC. L. J. 403, 410 (2012).

155. Schoenblum, *supra* note 148, at 2121.

156. Quinio v. Aala, 603 F. Supp. 3d 50, 51 (E.D.N.Y. 2022).

157. Beyer, *supra* note 2, at 15 (citing Harding v. Harding, 36 Cal. Rptr. 2d 184 (Cal. Ct. App. 1963); *In re* Pugh's Est., 139 P.2d 698 (Wash. 1932); *In re* Gulstine's Est., 6 P.2d 628 (Wash. 1932).

158. 285 P.2d 795 (N.M. 1955).

Mexico by an individual from Texas with his separate property was community property. Under Texas law, the income from separate property of a married individual is generally treated as community property, but under New Mexico law, such income is not community property and remains the separate property of the spouse who has received the earnings. The New Mexico Supreme Court interpreted the lex situs principle as indicating that the earnings generated on the rental property in New Mexico (which were purchased with source funds from separate property earned in Texas), needed to be evaluated according to New Mexico law. Due to the fact that New Mexico does not consider income from separate property as community property, the court determined that the income belonged to the deceased individual as separate property.

California Community Property Law Applied When a Texas Couple Owned California Property. Similarly, in *Commissioner v. Skaggs*,[159] The Court of Appeals for the Fifth Circuit held in a 2 to 1 decision that the marital rights of spouses in property depends upon the law of the place where the property is located, and that the law of the situs governs the nature of the income on such property. In *Skaggs*, a husband domiciled in Texas owned income-producing property in California that he had purchased with his separate property. The central property characterization issue hinged on whether the income generated by the property should be governed by the laws of the property's location, as per the lex situs rule, or if the domicile of the property owners should influence the tax treatment of the income on the property. The wife argued that the income from the property would have been deemed community property under the laws of Texas. However, the Court, in finding that California law applied to the characterization of the income on the property (thereby treating such income as separate property), emphasized that income taxation should adhere to the laws of the property's location, rendering the domicile of the property owners irrelevant in determining how the income should be taxed.[160]

The *Skaggs* Court, in coming to its conclusion, enunciated the interplay of these rules effectively:

159. 122 F.2d 721 (5th Cir. 1941), *cert. denied,* 315 U.S. 811 (1942).
160. *Id.* at 723-24.

> Marriage is a very personal matter, and its incidents are in general regulated by the law of the matrimonial domicile. But the Spanish and French laws touching community property, and those of California and Texas and other States derived from them, are held to be, in the vocabulary of the civilians, statutes real and not statutes personal; that is to say, they apply to things within a country's jurisdiction rather than to persons wherever they may be or go. *Hammonds v. Commissioner*, 10 Cir., 106 F.2d 420. It should follow that things, whether movable or immovable, actually situate[d] in a State and effectively within its power, should be governed by the law of that State. It is universally held that real or immovable property is exclusively subject to the law of the country or State in which it is situated, and no interference with it by the law of any other sovereignty is permitted. 11 Am.Jur., Conflict of Laws, § 30. And the question whether property is real or personal is to be solved by the law of the place where it is actually located. Id., Sec. 29. These rules apply to questions of the marital rights of spouses in property. 11 Am. Jur., Conflict of Laws, Sects. 50, 85; Id., Community Property, Secs. 10, 11.

It may be said then, that the marital property rights of spouses in personal property are governed by the law of the marital domicile, as per the partial-mutability doctrine, and that the property rights of spouses in real property are governed by the law of state where the real property is physically located, as per the lex situs rule.[161] However, as observed in the *Skaggs* decision above, the question of whether property is considered real or personal is to be solved by the law of the place where the property is actually located.[162] For example, states vary on the classification of a mobile home as real or personal property.[163]

It is worth noting that courts in common law states have recognized the community property nature of funds used to buy real property in the common law state, often finding that the spouses own the property as tenants in common.[164] Nevertheless, courts in community property states have held that real property in a common law property state is community property, in defiance of the lex situs rule.[165] As these cases suggest, it is not easy to

161. J. Thomas Oldham, Conflict of Laws and Marital Property Rights, 39 Baylor L. Rev. 1255 (1987) (*citing* Comm'r v. Porter, 148 F.2d 566 (5th Cir. 1945)).

162. *See also* 16 Am.Jur. 2d Conflict of Laws § 29.

163. *Classification, as real estate or personal property, of mobile homes or trailers for purposes of state or local taxation*, 7 A.L.R.4th 1016 (1981).

164. Beyer, *supra* note 2, at 21. (citing Rozan v. Rozan, 129 N.W.2d 694, 694 (N.D. 1964); Stone v. Sample, 62 So.2d 307, 307 (Miss. 1953); Rev. Rul. 72-433, 1972-2 C.B. 531, 1972 IRB LEXIS 172.).

165. Tomaier v. Tomaier, 146 P.2d 905, 905 (Cal. 1944).

predict whether a certain court will determine the property characterization issue to be one relating to personal property or real property, or even whether the court will apply American choice of law rules consistently and coherently.[166] This reality makes any analysis with an eye toward deriving a "general rule" from this body of law even more onerous.

C. Be Wary of Lurie – Physical Non-Real Estate Objects – What Law Applies?

Similar choice of law issues have arisen in the context of property owned as tenancy by the entireties that has been taken to a state that does not recognize tenancy by the entireties as a form of ownership. For example, two cases involving the same family, the Luries, and their impending bankruptcy claim, were decided by two different courts with conflicting outcomes. In *Lurie v. Blackwell*, the Supreme Court of Wyoming held that the law of the state of acquisition applied to determine the character of a sculpture.[167] The Luries had purchased the sculpture in Missouri, a tenancy by the entireties state, while both spouses resided there.[168] The couple later moved to Montana, which does not recognize tenancy by the entireties.[169] Years after moving to Montana, the couple sent the sculpture to Wyoming for a dealer to sell it.[170] A Missouri bankruptcy proceeding was pending and, in 1995, a judgment was rendered.[171] As a consequence, the sculpture was seized, but the wife claimed that it was held as tenancy by the entirety and thus was not subject to creditors.[172] The bankruptcy trustee, however, argued that Montana does not recognize tenancy by the entireties, and thus the sculpture should be subject to seizure.[173] The Wyoming Supreme Court held that the trustee could not seize the sculpture because the Luries were married at the time they acquired the sculpture in Missouri, they acquired the

166. Oldham, *supra* note 161, at 1272.
167. 51 P.3d 846, 846 (Wy. 2002).
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.* at 847.
172. *Id.*
173. *Id.*

sculpture in a state that recognized tenancy by the entirety, and creditors could thus not seize such property.[174]

In contrast, the Montana Supreme Court in the related case *of Lurie v. Sherriff of Gallatin County*, took the opposite approach and determined that the law of the situs controlled the characterization of tangible personal property.[175] Similar to *Lurie v. Blackwell*, at issue in *Lurie v. Sheriff of Gallatin County* was a sculpture purchased while the couple resided in Missouri, a tenancy by the entireties state, and was moved to Montana when the couple changed their residence to Montana, which is a non-tenancy by the entireties state.[176] The court held that the sculpture was no longer held as tenancy by the entireties because Montana does not recognize that form of property ownership, and as such, the sculpture was subject to the bankruptcy judgment.[177]

The *Lurie* cases demonstrate an important notion at the heart of these conflict of law issues: laws among states still vary, potentially leading to divergent results depending on the jurisdiction in which a legal matter is litigated, and the public policies and conflicting interests of other states that may be concerned with the case's outcome.

2. Save Yourself the Trouble – Have an Effective Choice of Law Agreement

The best way to avoid the application of the confusing principles above from a marital law standpoint is to have the married couple enter into an effective marital property agreement or premarital agreement which contains an effective choice of law provision. The courts will generally respect a married couple's choice of law to govern the property they acquire while married unless another state demonstrates a more compelling interest in seeing its laws applied. For example, where cases involve[178]deal with the rights of third parties, such as a creditor or someone who receives assets from one spouse, considerations of fairness may necessitate applying the law of the property's physical location.

174. *Id.* at 851.

175. Lurie v. Sheriff of Gallatin Cnty., 999 P.2d 342, 345 (Mont. 2000).

176. *Id.* at 344.

177. *Id.* at 345 (finding that sculpture was owned as joint tenancy or as tenancy in common property in Montana and sculpture was subject to execution on a validly issued writ.).

178. RESTATEMENT (SECOND) OF CONFLICT OF L. § 258 (AM. L. INST. 1971). *See also* Beyer, *supra* note 2, at 24.

Similarly, in cases involving movable property, greater weight will generally be given to the state where the spouses were domiciled at the time the movable was acquired than to any other contact in determining the applicable state law.[179]

Restatement (Second) of Conflict of Laws §187 reinforces the proposition above. It states that, in a contract, a court will typically honor the choice of law made by a married couple unless the chosen jurisdiction has no connection to the parties or the transaction, or if applying the chosen law contradicts a fundamental policy of a state that has a significantly stronger interest than the chosen state. In such cases, the state with the greater interest in the matter, which, absent the parties' choice of law would have been the governing law, takes precedence.[180]

On certain occasions, Florida courts have declined to uphold prenuptial agreements from foreign jurisdictions.[181] For instance, in 1961, before surviving spouses in Florida were given the right to an elective share (and the ability to waive such rights), a Florida court declined to enforce a prenuptial agreement from Quebec that waived dower rights. The court determined that enforcing such an agreement would contradict a strong public policy of Florida to have its laws apply to real property situated in the state.[182] However, in 1995, a Florida court upheld a choice of law provision designating Puerto Rico law regarding property other than real property in Florida, and remanded the case for further consideration of whether the choice of law clause was valid regarding Florida real property.[183] These cases underscore the importance of having a choice of law provision that designates both where the agreement will be litigated and what state law will apply.

This area of the law can be confusing, impractical, and far from definitive. Practitioners should be well-versed in both the laws in their state of practice and the laws of the state their clients are importing community property from.

179. RESTATEMENT (SECOND) OF CONFLICT OF L. § 234 (AM. L. INST. 1971).
180. *See id.* § 187.
181. Beyer, *supra* note 2, at 24.
182. *Id.* (citing Kyle v. Kyle, 128 So.2d 427, 427 (Fla. App. 1961)).
183. *Id.* at 25 (citing Estate of Santos, 648 So. 2d 277, 277 (Fla. App. 1995)); *see also* Franzen v. Franzen, 520 S.E.2d 74, 74 (N.C. App. 1999); Brown v. Gillespie, 955 S.W.2d 940, 940 (Mo. App. 1997); Estate of Levine, 700 P.2d 883, 883 (Ariz. App. 1985).

3. Community Property Should Retain its Character as Community Property after A Couple Moves to a Non-Community Property State.

Although Florida's UDCPRDA does not explicitly say that imported community property remains community property for purposes of testamentary dispositions, an American Law Report published in 1967 notes that "[w]hatever may be the underlying theoretical considerations that support it, the proposition that a change of domicil [sic] by a husband and wife from a state in which the community property system obtains to a state in which does not, or vice versa, has no effect on the character, as separate or community property, of property acquired prior to the removal or property into which such property can be traced, is almost universally accepted."[184]

To support this proposition, The American Law Report cites 39 cases dating back as far as 1826. In the 1827 Louisiana case of *Saul v. His Creditors*[185] the children of an insolvent father who had inherited from their mother commenced a proceeding claiming one-half of their father's property as the heirs of their mother, on the theory that her estate was community property.[186] The property involved was all acquired by the couple after they moved from the common law state of Virginia, where they married, to the community property state of Louisiana.[187] The opinion indicates that property acquired by the parties while they were residents of Virginia remained separate property and the property acquired while they were residents of Louisiana was community property.[188]

More than a century later, in 1937 the Eighth Circuit Court of Appeals case of *Johnson v. Commissioner*[189] reviewed an order of the Board of Tax Appeals redetermining deficiencies in the taxes imposed by the IRS. The taxpayer was married in Texas in 1886 and the wife had no assets of her own before or during the marriage.[190] In 1889, the couple moved from Texas (a community

184. A. M. Swarthout, s*upra* note 13, at § 3.
185. Saul v. His Creditors, 5 Mart. (n.s.) 569, 569 (La. 1827).
186. *Id.* at 571.
187. *Id.*
188. *Id.* at 608. "We conclude, therefore, that a community of acquests and gains did exist between the insolvent and the mother of the appellees, from the time of their removal into this state . . . "; *see also* Swarthout, s*upra* note 13.
189. Johnson v. Comm'r, 88 F.2d 952, 952 (8th Cir. 1937).
190. *Johnson,* 88 F.2d at 953.

property state) to Missouri (a non-community property state).[191] The taxpayer asserted that his income for the years 1927 through 1929 resulted from appreciation in value of the property that the couple brought from Texas, and therefore one-half of the income from the pre-1989 community property was taxable to his wife.[192] Joint federal income tax returns were not permitted under the U.S. Tax system until 1938.[193] The Court found that income and appreciation on the Texas community property was taxable one-half to the wife because after the couple left Texas "what was community property at the time continued to be community property."[194] This case has been cited on multiple occasions in law review and other articles discussing conflict of law and marital property rights.[195]

Based on the aforementioned case law it appears to the authors that while the UDCPRDA does not expressly declare that imported community property will remain as such for purposes of testamentary dispositions, the status of property as either community or separate will be determined by the laws of the state where the couple is domiciled when they acquire such property, or by the laws of the state where real property is physically located, unless or until they transmute out of community property treatment or place the property under a properly drafted and administered community property trust or into a homestead or tenancy by the entireties in Florida. The real key is not the label, as previously noted, but the rights that are retained or lost. Even if a "new" state (as it probably must) does respect the rights of each spouse to assets that were community property before they moved to the new state, it still begs the question of whether the assets are still community property under the law of the former state, territory or foreign country.

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191. *Id.* at 953–54.

192. *Id.* at 954.

193. Manton v. Comm'r, 11 T.C. 831, 835 (1948) (recognizing the allowance of joint returns beginning in 1938).

194. *Id.* at 835.

195. James L. Buchwalter, *Conflict of Laws Regarding Immovable or Real Property, Generally*, 15A C.J.S. CONFLICT OF L. § 89, n. 7 (2023); Walter L. Nossaman, *Tax Problems Affecting Community Property*, 26 TEX. L. REV. 26, 39 (1947).

V. CREDITOR RIGHTS IN COMMUNITY PROPERTY

Creditor rights vary based on the state where the community property is located. As a general rule, most of the community property states allow the creditor of one spouse to reach all community property.[196] In a community property state, when one spouse incurs a debt, the debt can be categorized as either an individual debt of that one spouse, or a community debt of both spouses.[197] Some states define the distinction between separate and community debts by statute, while others have relied solely on case law.[198] It is well settled that a creditor owed a separate debt may reach the separate property of the debtor spouse,[199] but not the separate property of the nondebtor spouse.[200] However, the laws among the community property states have substantial variation as to whether or not a creditor holding a separate debt may reach community property in order to satisfy the debt.

Community property states generally treat creditors' rights in one of two ways:

1. "Creditors Can Take It All" States

All states, except Texas,[201] allow collection of at least some post-marital obligations from 100% of the couple's community property. Some states (California, Idaho, and Louisiana) allow most categories of creditors to collect all debts of either spouse from 100% of community property.[202] Other states (New Mexico and Nevada) only allow this with respect to post-marital obligations of either spouse.[203]

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196. *See generally* Treacy, *supra* note 46.

197. HON. WILLIAM H. BROWN, LAWRENCE R. AHERN, III & CHRISTOPHER M. CAHILL, 1 THE LAW OF DEBTORS AND CREDITORS § 6:86. (2023).

198. *Id.* (citing N.M. STAT. ANN. § 40-3-9 (West 2023); LA. CIV. CODE. ANN. art. 2359, 60, 63 (2023)).

199. *See, e.g.*, CAL. CIV. CODE § 5121 (West 2023); IDAHO CODE Ann. § 32-911 (West 2023).

200. *See, e.g.*, LA. CIV. CODE. ANN. art. 2345 (2023); TEX. FAM. CODE. ANN. § 5.61 (West 2023); WASH. REV. CODE ANN. § 26.16.020 (West 2023). There are some exceptions to this principle (e.g., debts incurred for necessities). *See* CAL. FAM. CODE § 910-14 (West 2023); NEV. REV. STAT. ANN. § 123.090 (West 2023).

201. TEX. FAM. CODE ANN. §3.201 (West 2023).

202. *See* Andrea B. Carroll, *The Superior Position of the Creditor in the Community Property Regime: Has the Community Become a Mere Creditor Collection Device?*, 47 SANTA CLARA L. REV. 1, 1 (2007).

203. *Id.*

In California, Idaho, and Louisiana, creditors of the debtor spouse can reach all community property if the debt is incurred during the marriage.[204] Idaho and Louisiana courts have held similarly that community property can be reached to satisfy separate debts.[205] In California, community property earnings of one spouse can be segregated from the other community property in order to insulate it from the debts of the other spouse incurred prior to marriage.[206]

By contrast, Nevada has a statute that was enacted in 1873 which provides that the non-debtor spouse's interest in community property is not accessible to satisfy the debtor spouse's premarital obligations.[207]

New Mexico law requires the creditor to first seek payment from the separate property of the debtor spouse before being able to attempt to attach the debtor spouse's one-half ownership in the community property.[208]

Generally, if one spouse incurs a debt, and there is no community property to satisfy the debt, the non-liable spouse's separate non-community property is not available to satisfy the debt, although the debtor spouse's separate property would be available.[209]

Planners may consider transferring assets to irrevocable trusts established in asset protection trust jurisdictions that may retain community property status.

Older family members, such as the parents or surviving parent of the grantor of an asset protection trust may be given general powers of appointment over trust assets to obtain a step-up in income tax basis even during the life of both spouses.

2. "Community Debt" States

Some states (Arizona, Washington and Wisconsin) "characterize post-marital debts as either community debt or separate debt." Community debt is debt that has been incurred to

204. *Id.*
205. *Id.*
206. CAL. FAM. CODE § 911(a) (2001).
207. NEV. REV. STAT. § 123.050 (2023).
208. N.M. STAT. ANN. § 40-3-10(A) (2023).
209. Beyer, *supra* note 2, at 4.

benefit the marriage or family.[210] Community debt can be satisfied from all community property.[211] Separate ("non-community") debt may only be satisfied from the debtor spouse's half of community property or from the debtor spouse's contribution to community property.[212] In these states, the presumption is that debts are community debts.[213]

In Arizona, all debts incurred during the marriage are presumed to be community debt unless clear evidence is presented to show that the debt is separate.[214]

Washington statutes permit community debt to be satisfied from the community property of both spouses, and the separate property of the debtor spouse.[215]

Wisconsin courts divide the debts incurred after the marriage into (1) family purpose obligations; or (2) non-family purpose obligations.[216] Debt incurred for family purpose obligations can be satisfied through the debtor spouse's separate property and all marital property, including community property.[217] Non-family purpose obligations can be collected from the debtor spouse's separate property and the debtor spouse's one-half interest in the couple's community property.[218]

Texas law provides for different rules as to a creditor's ability to access community property, depending on whether the debt results from a contract or tort claim, and whether the debt was incurred before or during the marriage.[219]

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210. IRS, COLLECTION OF TAXES IN CMTY. PROP.STATES, *Cmty. Debt States* (2018), https://www.irs.gov/irm/part25/irm_25-018-004.

211. *Id.*

212. *Id.*

213. *Id.*

214. ARIZ. REV. STAT. ANN. § 25-215 (2023) note (Community property and obligations—in general) (citing *Schlaefer v. Fin. Mgmt. Serv. Inc.*, 996 P.2d 745, 748 (Ariz. Ct. App. 2000)).

215. WASH. REV. CODE § 11.10.030 (2022).

216. *See St. Mary's Hospital Medical Center v. Brody*, 519 N.W.2d 706, 709 (Wis. Ct. App. 1994) (citing UNIF. MARITAL PROP. ACT § 8 cmt. at 26-27 (UNIF. L. COMM'N., 1996)).

217. WIS. STAT. § 766.55 (2023); Howard S. Erlanger & June M. Weisberger, *From Common Law Property to Community Property: Wisconsin's Marital Property Act Four Years Later*, 1990 WIS. L. REV. 769, 778-79 (1990).

218. Treacy, *supra* note 46.

219. For an excellent discussion of creditor's rights with respect to Texas community property, see Thomas M. Featherston, Jr, Creditors' Rights in and to the Marital Estate: What Property is Liable for which Debts?¸2013 ADVANCED EST. PLAN. & PROB.COURSE, State Bar of Texas (June 26, 2013).

Under the Tennessee Community Property Act, the obligation of one spouse incurred before or during the marriage can be satisfied only from that spouse's one-half of the community property trust.[220] On a spouse's death, half of the value of the trust reflects the deceased spouse's share and the other half reflects the surviving spouse's share.[221] Similarly, Florida's Community Property Trust Act provides that the debts and obligations of one spouse may be satisfied from that spouse's one-half share of the trust, regardless of whether the debt or obligation is incurred before or during the marriage.[222] As such, the Florida community property trust may not be attractive to spouses who prioritize creditor protection planning since assets owned as tenants by the entireties are generally being protected from the debts and obligations of one spouse. A joint debt or obligation of both spouses may be satisfied from the assets of the trust, which is similar to the treatment of joint debts and obligations vis-à-vis tenants by the entirety assets. An LLC owned partly by a community trust and partly by another person or family entity may facilitate charging order protection, as further discussed below.

Any further survey of the variations in the law in this area would exceed the scope of this discussion, however, a chart entitled "Creditor Rights in Community Property States" provided at the end of this article gives the matter further attention.

VI. ESTATE AND GIFT TAX CONSIDERATIONS

1. Gifts of Community Property

Gifts of community property made by one spouse are automatically considered to have been made one-half by each spouse, so that "gift splitting" by the filing of a gift tax return by the non-donor spouse is not required for community property transfers.[223] Steve Akers instructs the reader to "not make a gift of community property to a trust in which a spouse is a beneficiary if the desire is to exclude the trust assets from the gross estates of the spouses.[224] The beneficiary spouse will be treated as making

220. TENN. CODE ANN. § 35-17-106 (West 2023).
221. TENN. CODE ANN. § 35-17-107 (West 2023).
222. FLA. STAT. § 736.1506 (2022).
223. Akers, *supra* note 70, at 9.
224. *Id.*

the gift of one-half of the assets with a retained beneficial interest subject to 2036(a)(1)."[225]

Spouses generally must both consent to gifts of community property, and a gift of community property made without the proper authority is voidable at the option of the non-consenting spouse.[226] [227]

Furthermore, it is advisable to follow correct protocols when designating a beneficiary for a community property IRA or life insurance policy other than the surviving spouse, to prevent unforeseen or unintended outcomes.[228] If one spouse intends to leave a community property IRA or life insurance policy to someone other than their spouse, it is important to secure the other spouse's consent while they are still alive.[229] Typically, both spouses have a right to dispose of one-half of a community property IRA or life insurance policy, regardless of which spouse is the account holder or policyholder and with respect to beneficiary designations."[230] For example, under California law, a surviving spouse has the right to reclaim from the designated beneficiary their one-half interest in the community property if they did not consent to the beneficiary designation.[231]

Despite the surviving spouse's approval of a beneficiary designation, practitioners should consider whether to convert the community property asset into separate property to prevent it from being considered a gift by the surviving spouse upon the death of the policyholder or account holder.[232]

2. Estate Tax Implications

Much like how the community property system automatically equalizes gifts, it also automatically equalizes estates between spouses. For estate tax purposes, when the first spouse dies, his or her gross estate includes one-half of each item of the couple's community property, in addition to his or her separate property.[233]

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225. *Id.*
226. Trimble v. Trimble, 219 Cal. 340, 26 P.2d 477 (1933).
227. Beyer, *supra* note 2, at 5.
228. *Id.* at 39.
229. *Id.*
230. *Id.* at 40, citing Nev. Rev. Stat. §123.230; RCW §6.15.020(6).
231. Cal. Prob. Code § 102.
232. Beyer, *supra* note 2, at 40.
233. Michaelle D. Rafferty, *Use of Joint Spousal Trusts in Community Property States: Still the Gold Standard of Estate Planning?*, 67 PRAC. LAW. 47 (2021).

Because of this, most well-advised couples who reside in community property states will either transmute out of community property treatment when appropriate or consider holding the community property in a Joint Trust that breaks up into two separate parts when one spouse dies.[234] Part one consists of the half ownership of the assets that continues in the name and under the control of the surviving spouse.[235] The other half of the assets will typically pass into a Credit Shelter Trust, with an overflow provision into a QTIP Trust for the surviving spouse and descendants.[236] More detail on the estate tax implications of community property is provided below.

3. Gift Tax on Funding

Planners should be aware that the funding of a community property trust may be considered to be a taxable gift by one spouse to the other, depending upon how much in assets each spouse transfers to the trust, and what legal rights each spouse will have over the trust.[237]

Steve Akers describes the issue masterfully in his ACTEC 2013 Fall Meeting Musings:

> Completed gift issues can arise even though the joint trust is revocable.
>
> In community property states, if the assets will pass to or for the benefit of the surviving spouse at a spouse's death and if spouses must act jointly to revoke the trust, there may be a completed gift upon creating the trust because the trust could be revoked only with the consent of a person who has a substantial adverse interest (reg.§ 25.2522-2(e)), and that causes a completed gift under the gift tax regulations. The older spouse may be treated as making a gift to the younger spouse that would not qualify for the marital deduction (because it would be a terminable interest without a mandatory income interest). Typically, joint trusts with community property provide that either spouse may unilaterally revoke the trust as to all community property held in the trust (i.e., both halves of

234. *Id.* at 51-52.
235. *Id.* at 52.
236. *Id.*
237. Karen Boxx, *The Use of Joint Revocable Trusts for Married Couples*, 61 PRAC. LAW. 53 (2015).

> community property). (The community property would be subject to the same ownership and management rights, but the trust layer would have been removed.)
>
> The Uniform Trust Code states that for revocable trusts holding community property, "the trust may be revoked by either spouse acting alone but may be amended only by the joint action of both spouses." (§602(b)).
>
> In common law property states, joint trusts often state that the contributions are treated as if made one-half by each spouse, that on revocation one-half of the trust assets would pass to each spouse, and that if a distribution is made to one spouse, an equal distribution is made to the other spouse.[238]

VII. CREATING A FLORIDA COMMUNITY PROPERTY TRUST

Florida's Community Property Trust Act (the "Act") introduces Florida Statutes Sections 736.1501 through 736.1512, and is very similar to the Alaska, Tennessee, South Dakota and Kentucky Acts.[239] The Act provides that "'Community Property' means the property and the appreciation of and income from the property owned by a qualified trustee of a community property trust during the marriage of the settlor spouses."[240]

A community property trust is a "trust that complies with s. 736.1503 and is created on or after July 1, 2021."[241] Therefore, it appears that a pre-existing trust cannot be converted into a community property trust, but trust assets existing on or before July 1, 2021, can be "decanted" or transferred into a new community property trust.

As stated above, "Community Property" is defined under section 732.1502(1) as "the property and the appreciation of and income from the property owned by a qualified trustee of a Community Property Trust during the marriage of the settlor spouses."[242] In defining "community property," section 732.1502(1) continues, stating: "The property owned by a community property trust pursuant to this part and the appreciation of and income from

238. *Id.*
239. Sneeringer, *supra* note 30, at 35.
240. FLA. STAT. § 736.1502(1) (2022).
241. *Id.* § 736.1502(2).
242. *Id.* § 736.1502(1).

such property shall be deemed to be community property for purposes of general law."[243] Readers should be aware that there is no definition of "general law" provided by the statutes, but it seems clear that it is intended that the property placed in Florida community property trust will be community property for purposes of obtaining stepped-up fair market value income basis under Internal Revenue Code Section 1014(b)(6). Jonathan Blattmachr asks, "could Florida pass an enforceable law saying that assets that were community property under the law of the couple's former domicile remain community property under the laws of that former domicile?"[244] Florida could pass a law that says this, but can such a law actually apply?[245]

A "qualified trustee" is defined under Florida Statute Section 736.1502 to be either "(a) a natural person who is a resident of [Florida], or (b) a company authorized to act as a trustee in [Florida]."[246] It is possible that almost any company or LLC formed in Florida could serve as a "Company Authorized As A Trustee in Florida" because Florida law does not prevent a company from acting as a trustee.

736.1502 defines settlor spouses to mean a "married couple who establishes a community property trust pursuant to (the statute)."[247]

For a married couple to form and maintain a Florida community property trust, the Act requires that one or both settlor spouses transfer property to a trust that meets the following four requirements:

"1. Expressly declares that the trust is a community property trust within the meaning of this [statute].

2. Has at least one trustee who is a qualified trustee "provided that both spouses or either spouse also may be a trustee."

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243. *Id.*

244. *See* Jonathan G. Blattmachr et al., *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP., PROB. AND TR. J. 615, 624 (1999) (questioning whether the state property laws of an individual's prior state can transfer to a new state when the individual moves).

245. *See id.* at 617 (detailing how a new look at community property laws can effectively enable an individual to choose a community property option and outlining the tax advantages that could come with allowing residents to utilize community property trusts). The IRS may argue otherwise.

246. FLA. STAT. § 736.1502(1).

247. *Id.*

3. Is signed by both settlor spouses consistent with the formalities required for the execution of a trust under this chapter.[248]

4. Contains substantially the following language in capital letters at the beginning of the community property trust agreement:

"THE CONSEQUENCES OF THIS COMMUNITY PROPERTY TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND UPON THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD BE SIGNED ONLY AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK COMPETENT AND INDEPENDENT LEGAL ADVICE."[249]

Florida Statute Section 736.1504 provides that the trust agreement that establishes the community property trust may include an agreement by the settlor spouses upon the following:

"a. The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located.

b. The management and control of the property transferred into the trust.

c. The disposition of the property transferred into the trust on dissolution, death, or the occurrence or nonoccurrence of another event, but subject to both of the following limitations:"[250]

> **Limitation 1** - Under Florida Statute Section 736.1507, upon "the death of a spouse, one-half of the aggregate value of the property held in a community property trust . . . is not subject to testamentary disposition by the decedent spouse or distribution under the laws of succession . . . [t]]he other one-half . . . reflects the share of the decedent spouse and is subject

248. FLA. STAT. § 736.1503(l).
249. *Id.*
250. FLA. STAT. § 736.1504(1)(a)–(c).

to testamentary disposition or distribution under the laws of succession of the state." [251]."

Limitation 2 - Florida Statute 736.1508 states that, upon dissolution of the marriage of the couple, the community property trust will terminate, and the trustee will distribute one-half of the trust assets to each spouse.[252]

It is important to note that Florida Statute Section 736.1508 appears to intend to provide that the married couple can contractually agree to share the assets of the community property trust other than equally in the event of the dissolution of marriage but this does not seem clear to the authors.[253]

The authors are not sure whether the spouses can have a prenuptial or postnuptial agreement that would require the equal ownership of assets received from the community property trust to be adjusted after receipt, such as upon the event of a divorce filing, after the literal language of the statute has been satisfied by facilitating an equal distribution.

It seems that once the assets are distributed from a Florida community property trust to the spouses while living, they will be considered to be the couple's separate property. Unlike Alaska law, which provides that assets contributed to an Alaska community property trust and declared to be community property under Alaska law remain community property under Alaska law if and when distributed out, Florida law does not continue to treat the assets as community property (as Florida has no community property law outside of a Florida community property trust).[254]

d. "Whether the trust is revocable or irrevocable." The presumption is that the trust is revocable unless stated otherwise.[255]

There are advantages to having an irrevocable community property trust. This includes the reduction of risk that one or more

251. FLA. STAT. § 736.1507.
252. FLA. STAT. § 736.1508(1).
253. FLA. STAT. § 736.1508(3).
254. *Alaska Property Division FAQs*, MARITAL LAWS, https://www.maritallaws.com/states/alaska/property-division (last visited July 18, 2023).
255. FLA. STAT. § 736.1504(1)(d). *See also supra* note 50 (supporting the assertion that an irrevocable community property trust includes a reduction of the risk of undue influence issues).

individuals may unduly influence the married couple to change the trust and to lose access to the assets thereof.[256]

e. Any other matter that affects the property transferred to the trust and does not violate public policy or general law . . . or result in the property not being treated as community property under the laws of a relevant jurisdiction." ."[257] The statute further provides that in the event of the death of a settlor spouse, the surviving spouse may amend the trust with respect to the disposition of the surviving spouse's one-half share of the trust "regardless of whether the agreement provides that the community property trust is irrevocable," or regardless of what the trust agreement says to the contrary.[258] This (and Limitation 1 described above[259]) underscores the principle that the surviving spouse's one-half of the community property trust is the surviving spouse's property that vests in the surviving spouse upon the first dying spouse's death. Moreover, this prevents distributions from being made to descendants, charities, or others from a community property trust, and causes a loss of flexibility, but enhances the protection of the married couple themselves.

Many married couples enter into joint trusts based upon the premise that the surviving spouse would be required to have the assets remain under the trust and be used only for the health, education, maintenance, and support of the surviving spouse and common descendants to preserve the assets for the common descendants or other family or charities that may be favored by the first dying spouse.[260] This is apparently not possible under a Florida community property trust, at least to the extent of the surviving spouse's 50% interest in the community property trust.

Furthermore, during the joint lifetimes of the spouses, they "shall be deemed to be the only qualified beneficiaries of a community property trust until the death of one of the settlor spouses, regardless of whether the trust is revocable or irrevocable."[261] "After the death of one of the settlor spouses, the

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256. *What is an Irrevocable Trust?*, METLIFE (Nov. 3, 2022), https://www.metlife.com/stories/legal/irrevocable-trust/.

257. FLA. STAT § 736.1504(1)(e).

258. FLA. STAT. § 736.1504(4).

259. FLA. STAT. § 736.1507.

260. Zachary F. Lamb, *Joint Trusts: A Useful Tool for Some Married Couples*, WARD AND SMITH (July 5, 2022), https://www.wardandsmith.com/articles/joint-trusts-a-useful-tool-for-some-married-couples.

261. FLA. STAT. § 736.1504(4).

surviving spouse shall be deemed to be the only qualified beneficiary as to his or her share of the community property trust."[262] This is important because qualified beneficiaries have certain rights under Florida law, such as the right to receive trust accountings, and the right to access information regarding the trust instrument and the trust's activities.[263]

"Qualified beneficiary" is defined under Florida Statute Section 736.0103 as "a living beneficiary who, on the date the beneficiary's qualification is determined:

(a) Is a distributee or permissible distributee of trust income or principal;

(b) Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (a) terminated on that date without causing the trust to terminate; or

(c) Would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date."[264]

Despite the advantages of a Florida community property trust, a married couple transferring assets to a community property trust may be causing assets that would otherwise be protected from creditors to be accessible to them, such as if and when the married couple may transfer tenants by the entirety's assets, annuities, life insurance, 529 Plans, and wage accounts to a community property trust.[265], [266]

Some couples may have the community property trust own the majority interest in an LLC that will have other members. The statutes are silent as to whether a charging order will be the sole remedy of the judgment creditor who has the right to receive one-half of the community property trust assets by reason of being owned by one spouse, or all of such assets by reason of being owned

262. *Id.*

263. *See generally* FLA. STAT. § 736.0813.

264. FLA. STAT. § 736.0103(19).

265. Joseph M. Percopo, *Understanding The New Florida Community Property Trust, Part II,* THE FLORIDA BAR (Oct. 2022), https://www.floridabar.org/the-florida-bar-journal/understanding-the-new-florida-community-property-trust-part-ii/#u6e00.

266. For an additional discussion on Florida Community Property Trusts, see HOWARD M. ZARITSKY & FARHAD AGHDAMI, TAX PLANNING FOR FAMILY WEALTH TRANSFERS AT DEATH
4.07[7][c][v] (Thomson Reuters/WG&L 2014) and HOWARD M. ZARITSKY & FARHAD AGHDAMI, TAX PLANNING FOR FAMILY WEALTH TRANSFERS AT DEATH § 8:77 (Thomson Reuters/WG&L, 5th ed., 2013).

by the other spouse, although it seems that the protection provided by Florida's charging order law will apply if an interest in a multiple member LLC is owned by a Florida community property trust.[267]

The safest approach would be to have voting-member interests owned by the minority member so that the creditor can only reach an LLC member interest that would not be able to vote to authorize or require liquidation or distribution from the LLC; however, a community property trust that does not control the voting rights of an entity that it owns part of may result in less than a full fair market value basis if the IRS argues that there should be a significant discount in value.[268]

VIII. HOMESTEAD ISSUES

Furthermore, Florida Statute Section 736.151 entitled "Homestead Property" provides that "[p]roperty that is transferred to or acquired subject to a community property trust may continue to qualify or may initially qualify as . . . homestead . . . provided that the property would qualify as . . . homestead [with title as] held in one or both of the settlor spouse's individual names", and the "[s]ettlor spouses shall be deemed to have beneficial title in equity to the homestead property held subject to a community property trust for all purposes, including for the purposes Section 196.031."[269]

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267. Florida's Charging Order Statute, FLA. STAT. § 605.0503, provides the following "[A] charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company." FLA. STAT. § 605.0503(6) further provides that: "In the case of a limited liability company that has more than one member, the remedy of foreclosure on a judgment debtor's interest in the limited liability company or against rights to distribution from the limited liability company is not available to a judgment creditor attempting to satisfy the judgment and may not be ordered by a court." *Id.*

268. *See* Jospeh M. Percopo, *Understanding the New Florida Community Property Trust, Part II*, THE FLORIDA BAR (Oct. 2022), https://www.floridabar.org/the-florida-bar-journal/understanding-the-new-florida-community-property-trust-part-ii/#u6e00 (discussing the various implications on LLCs of Florida's new community property law).

269. FLA. STAT. § 736.151, which reads as follows: "Homestead Property. - (1) Property that is transferred to or acquired subject to a community property trust may continue to qualify or may initially qualify as the settlor spouses' homestead within the meaning of s. 4(a)(1), Art. X of the State Constitution and for all purposes of general law, provided that the property would qualify as the settlor spouses' homestead if title was held in one or both of the settlor spouses' individual names. (2) The settlor spouses shall be deemed to have beneficial title in equity to the homestead property held subject to a community property trust for all purposes, including for purposes of s.196.031."

Florida Statute Section 196.031 provides for the property tax treatment of homestead, which allows for a reduction of up to $50,000 in the assessed value of a Florida homestead for county property tax purposes.[270] The homestead exemption includes the additional benefit of an annual limitation in the increase in the assessed value of homestead property to the lesser of 3% or the increase in the Consumer Price Index (CPI) over the prior year.[271]

Under the Florida Constitution, the first dying spouse can only devise Florida homestead property to the surviving spouse unless waived in proper form.[272] Otherwise, if the homestead owner dies as the sole owner of homestead property and leaves a spouse and one or more descendants, then the spouse receives a life estate and the descendants receive a vested remainder interest, all by operation of law, notwithstanding what the will or trust of the homestead owner provided.[273] The Florida Statutes permit the surviving spouse to elect to receive a 50% undivided interest, and to have a 50% undivided interest in lieu of a life estate, and to have it vest in the descendants of the decedent homestead owner if a timely election is filed.[274] The 2014 case of *Stone v. Stone*[275] addressed this shortcoming by allowing a deed from a spouse to constitute a waiver of homestead rights, so that the first dying spouse's interest could be devised as the first dying spouse wished.[276] Since the *Stone* case, Florida Statute 732.7025 was enacted to provide a safe harbor method of having a spousal waiver of homestead by deed.[277] There is no language regarding the waiver of homestead rights included in the Florida Community Property Trust Act, so a spouse wishing to do so must rely on

270. FLA. STAT. § 196.031(b), which reads as follows: "Every person who qualifies to receive the exemption provided in paragraph (a) is entitled to an additional exemption of up to $25,000 on the assessed valuation greater than $50,000 for all levies other than school district levies."

271. Jerry Holland, *Save Our Homes - Assessment Cap On Homesteaded Property*, COJ, https://www.coj.net/departments/property-appraiser/save-our-homes-amendment-10 (last visited Mar. 26, 2023).

272. *See* FLA. STAT. § 732.4015.

273. *See* Jeffrey S. Goethe and Jeffrey A. Baskies, *Homestead Planning Under Florida's New "Safe Harbor" Statute*, FLA. BAR J., May/June 2019 at 36. "Devise-restricted homestead that is not validly devised or is not devisable descends as other intestate property, unless the decedent is survived by a spouse and one or more descendants, in which case the surviving spouse receives a life estate with a vested remainder in the then living descendants, per stirpes." *Id.*; *see also* FLA. STAT. § 732.401(1).

274. *See* FLA. STAT. § 732.401(2).

275. *See* Stone v. Stone, 157 So. 3d 295, 301-305 (Fla. Dist. Ct. App. 2014).

276. *Id.* at 305.

277. *See* FLA. STAT. § 732.7025(1).

Florida Statute 732.7025, or must execute an agreement to waive homestead rights.[278] Waiving homestead rights via deed under the new statute requires the following or substantially similar language to be included: "By executing or joining this deed, I intend to waive homestead rights that would otherwise prevent my spouse from devising the homestead property described in this deed to someone other than me."[279] Florida Homestead rights can also be waived via a written contract or agreement, signed by the waiving party in the present of two subscribing witnesses.[280]

Perhaps more importantly, the community property trust statute provides comfort that the homestead creditor protection benefits afforded by Florida law will apply despite the property being titled under a trust and not directly in the spouses' names.[281] It would seem that this principle would be extended to cause homestead creditor protection to apply where the homestead property is owned by a Floridian's revocable trust that is not a community property trust. Many practitioners have believed homestead creditor protection would apply in such event,[282] but in the case of *In re Bosonetto,* a 2001 Middle District of Florida Bankruptcy Court Judge held that the homestead creditor protection does not apply to homestead property owned under a revocable trust.[283]

In *Bosonetto*, an 89 year-old widow signed a revocable trust and apparently intended to convey all of her tangible and intangible property thereto. The trust agreement provided that "even though record ownership or title, in some instances, may presently or in the future, be registered in my individual name, in which event such record ownership shall hereafter be deemed held in trust even though such trusteeship remains undisclosed."[284] A preliminary issue in the case was whether the trust, or Ms.

278. FLA. STAT. § 732.702. Homestead rights can also be waived by a written agreement under section 732.702, Florida Statues.

279. FLA. STAT. § 732.7025(1).

280. *See* FLA. STAT. § 732.702(1). FLA. STAT. § 732.702(2) further provides that each spouse shall make a fair disclosure to the other of that spouse's estate if the agreement or contract is executed after marriage. No disclosure shall be required for an agreement executed before marriage. *Id.*

281. *See* FLA. STAT. § 732.7025.

282. *Florida Homestead Creditor Protection,* GONZALEZ, SHENKMAN & BUCKSTEIN PL https://www.gsblawfirm.com/florida-homestead-creditor-protection (last visited Apr. 4, 2023).

283. Crews v. Bosonetto (*In re* Bosonetto), 271 B.R. 403, 406-07 (Bankr. M.D. Fla. 2001).

284. *Id.* at 405.

Bosonetto individually, owned the homestead property. The Bankruptcy trustee successfully argued that because of the above language and Ms. Bosonetto's intent the monies that were used to purchase the homestead property came from the proceeds of a contract for deed which was owned by the Trust, that the homestead property was also owned by the trust, and not by Ms. Bosonetto individually.[285] As a result, the court, noting that the Florida Constitution provides that the homestead exemption to property owned by a "natural person," found that "because a trust is not a natural person, Defendant Bosonetto may not claim the Florida property is covered by the homestead exemption."[286]

Since this controversial 2001 decision was published, there have been three Florida District Court of Appeals cases and two Bankruptcy Court cases[287] that declined to follow the *Bosonetto* decision and found that homestead property owned under a revocable trust are protected from creditors, but the question of whether a Florida homestead loses its protection from creditors upon transfer to a revocable trust has not been ruled on by the Florida Supreme Court. It is worth noting, however, that homestead property held in trust can still receive the Florida homestead tax exemption that includes a 3% cap on assessed value increases, as long as the trust grants a present possessory interest for life to the individual or couple claiming the exemption.[288] Additionally, the Florida Attorney General, citing Fla. Stat. §196.041(2), has confirmed that a trust beneficiary specifically granted a life estate in real property under a trust agreement may qualify for the homestead exemption.[289] Opinions of the Florida Attorney General are not law or binding precedent, although they are commonly relied upon by practitioners.[290]

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285. *Id.* at 406. It was stipulated in the findings of fact that the contract for deed was specifically assigned to the revocable trust. *Id.*

286. *Id.* at 407.

287. *Compare In re* Alexander, 346 B.R. 546 (Bankr. M.D. Fla. 2006), *with In re* Edwards, 356 B.R. 807 (Bankr. M.D. Fla. 2006) (explaining that the same Middle District Court reached the opposite conclusion, finding that real property in a revocable trust was eligible for the homestead exemption).

288. Alan Gassman, Brock Exline, & Peter Farrell, *Designing Trust Systems for Florida Residents: Planning Strategies, Things You Should Know, and Traps for the Unwary,* FLA. BAR J., July/Aug 2023, at 28. *See also* Blakely Moore, *Can a Trust Qualify for the Florida Homestead Tax Exemption?*, PTM TRUST AND ESTATE LAW (Oct 28, 2022), https://ptmlegal.com/blog/can-a-trust-qualify-for-the-florida-homestead-tax-exemption.

289. Fla. Att'y Gen. Op. AGO 90-70 (1990); Fla. Att'y Gen. Op.AGO 2005-52 (2005).

290. *Requesting an Attorney General Opinion*, ATT' Y GEN. STATE OF FLA., https://www.myfloridalegal.com/attorney-general-opinions/frequently-asked-questions-

The new statute under Florida's Community Property Trust Act, which specifically provides that a homestead owned by a community property trust is protected from creditors, might be read to indicate that the Florida Legislature believes that property owned by a revocable trust would not be protected, but for having to pass this section of the statute to clarify that a community property trust can own homestead property without abrogating the creditor protection afforded by the Florida Constitution.

In addition, if this is only statutory protection because the Florida Constitution may not save the day, as asserted in *Bosonetto*,[291] then the Florida fraudulent transfer statute would still apply to a transfer of homestead by a debtor to a community property trust. The famous 2005 Florida Supreme Court case of *Havoco of America, Ltd. V. Hill*[292] established that the Florida homestead creditor protection trumps the Florida fraudulent transfer statute and would apply to the transfer of a statutorily exempt asset where the creditor protection of homestead emanates from the Florida Constitution. Married couples with potential creditor issues should therefore be advised that a transfer to a community property trust may be reversed by a creditor who existed or was expected to exist at the time of the transfer. While the general rule in Florida is that a creditor exempt asset can be transferred or converted into another creditor exempt asset without being considered to be a transfer for the purpose of avoiding creditors under the Florida fraudulent transfer statute, the Florida Supreme Court the has ruled that a transfer from homestead to another creditor exempt asset will be a transfer that can be set aside under the fraudulent transfer statute if done for the purpose of avoiding a creditor.[293]

Married couples may wish to serve as trustees of their community property trust but also have confidentiality as to the ownership of their homes. It is possible, and many times advisable, to have the community property trust be the sole beneficiary of a land trust which has another person or entity as its trustee so that

about-attorney-general-opinions#:~:text=Attorney%20General%20Opinions%20serve%20to,in%20a%20court%20of%20law.

291. Crews v. Bosonetto (*In re* Bosonetto), 271 B.R. 403, 406-07 (Bankr. M.D. Fla. 2001).

292. Havoco of Am., Ltd. v. Hill, 790 So. 2d 1018 (Fla. 2001), *opinion after certified question answered*, 255 F.3d 1321 (11th Cir. 2001).

293. Orange Brevard Plumbing & Heating Co. v. La Croix, 137 So. 2d 201, 206 (Fla. 1962).

the deed on the public record will show the name of an individual or LLC serving as Trustee other than the homeowners. In our experience, the county property appraisers in most, if not all counties, will permit the homestead exemption to be enjoyed while not revealing the names of the actual homesteading beneficial owners on the property appraiser website. Some property appraisers require the name of the beneficial owners to be included in one cell on their website, but that cell will only display a certain number of letters. For example, if the website can only display twenty characters, and the trust is beneficially owned for John and Molly Smith, the property appraiser may put "Hillary S. Jones, Esq. as Agent for her clients John and Molly Smith. If the property appraiser only lists the first 20 characters, then the property appraiser website will only show "Hillary S. Jones, Esq. a."

IX. BUILT IN PROTECTION FROM UNDUE INFLUENCE ETC.

Under Florida Statute Section 736.1512 entitled "Unenforceable trusts," a community property trust executed during marriage is not enforceable if:

(a) "The trust was unconscionable when made;(b) The spouse against whom enforcement is sought did not execute the community property trust agreement voluntarily; (c) The community property trust was the product of fraud, duress, coercion, or overreaching; or (d) before execution, the spouse against whom enforcement was sought:

(1) was not given a fair and reasonable disclosure of the property, and financial obligations of the other spouse, (2) Did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided, or

(3) did not have notice of the property or financial obligations of the other spouse."[294]

The above safeguard puts lawyers and other planners in a position where they must assure that each spouse is given fair and reasonable disclosure of the property and financial obligations of the other spouse.

294. FLA. STAT. § 736.1512 (2022).

Finally, Florida Statute Section 736.1512(3) provides that "a community property trust may not be deemed unenforceable solely on the fact that the settlor spouses did not have separate legal representation when executing the trust."[295] Nevertheless, it would be most prudent to recommend that each spouse should have separate independent legal counsel, or to at least ask each spouse to waive the opportunity to have separate independent legal counsel. It also is appropriate for the spouses to provide each other with full and fair disclosure of their respective assets and to observe other formalities applicable to the execution of marital agreements.

X. ADVANTAGES OF THE FLORIDA COMMUNITY PROPERTY TRUST

The two reasons that Florida's Community Property Trust Act may be preferred over other "opt-in" community property trust jurisdictions are:

(1) The creditors of one spouse can only reach such spouse's one-half of the assets held in a Florida community property trust (and generally not the other spouse's one-half of the trust assets).[296] Under the Alaska and South Dakota community property trust laws creditors of one spouse can reach all assets held in a community property trust.[297]

(2) More individuals will know a lawyer or potential trustee in Florida because Florida has a significantly larger population than Alaska, South Dakota, Tennessee, and Kentucky.[298]

295. *Id.*

296. Christopher Weeg, *What is a Florida Community Property Trust?,* COMITER, SINGER BASEMAN & BRAUN (Apr. 22, 2022), https://www.comitersinger.com/blog/what-is-a-florida-community-property-trust/.

297. Jay Adkisson, *Community Property and Creditor-Debtor Law Explained*, FORBES (May 20, 2012, 12:21 PM), https://www.forbes.com/sites/jayadkisson/2012/05/20/community-property-and-creditor-debtor-law-explained/?sh=2d480b514233; *see* Jonathan G. Blattmachr, Howard M. Zaritsky & Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & Tr. J. 615 (1999).

298. *Population Estimate for 2022*, STATS AM., https://www.statsamerica.org/sip/rank_list.aspx?rank_label=pop1 (last visited July.18, 2023).

Any person residing in the State of Florida can serve as the trustee or a co-trustee under a Florida community property trust.[299]

Before the enactment of the Florida Community Property Trust Act on July 1, 2021, married couples who wanted to enter into a community property trust had to have a trust company duly registered with Alaska, South Dakota, Kentucky, or Tennessee, or an individual residing in one of those states, serve as trustee of the trust.[300] Florida's Community Property Trust Act works the same way by permitting any Floridian or a qualified company to act as a trustee of a Florida community property trust, which broadens the universe of potential trustees of a community property trust established by Floridians.[301]

Specifically, Florida has approximately 1.5 times the population of the states of Alaska, South Dakota, Kentucky, and Tennessee combined, and one or both of the spouses can serve as sole trustee or co-trustees of the trust, by themselves or with others.[302]

As of 2022, the most populated states in the United States are (with the population numbers estimated):[303]

California (39,029,342 people)

Texas (30,029,572 people)

Florida (22,244,823 people)

New York (19,677,151 people)

Pennsylvania (12,972,008 people)

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299. Blakely Moore, *Everything You Need to Know About Florida's Community Property Trust Act*, PTM TRUST AND ESTATE LAW (Dec. 16, 2022), https://ptmlegal.com/blog/everything-you-need-to-know-about-floridas-community-property-trust-act.

300. *United States: To Trust or Not to Trust– Florida's New Statutes Pave the Way for Expansion of Individual's Succession Planning Opportunities*, BAKER MAKENZIE (Aug. 26, 2021), https://insightplus.bakermckenzie.com/bm/tax/united-states-to-trust-or-not-to-trust-floridas-new-statutes-pave-the-way-for-expansion-of-individuals-succession-planning-opportunities.

301. Moore, *supra* note 299.

302. *See Population Estimate for 2022*, *supra* note 298.

303. *Id.*

Furthermore, a great many individuals who reside in the Northeast or the Midwest have close friends, relatives, or advisors in Florida that can serve as trustees of a community property trust.

For most married couples, the benefit of having a community property trust is that all assets under a community property trust will receive a fair market value date of death basis for federal income tax purposes if the Community Property Act[304] works, which is an issue described below. Other purposes include the avoidance of probate and guardianship, and having a trust agreement that can receive distributions under beneficiary designations if the surviving spouse does not survive. Most married couples will make IRAs, pensions, and life insurance payable to a surviving spouse or a trust for a surviving spouse that will be separate from a Florida community property trust, as described below.

1. Example

Harry and Sally Katz-Deli live in New York and are in their 70s. They have $3,000,000 worth of publicly traded stock for which they paid approximately $500,000. Neither of them has a crystal ball with respect to who will survive the other.

If they sell the stock now, they will have a $2,500,000 capital gain and may have to pay a 23.8% combined federal income tax and net investment income tax, not to mention a 9.65% New York state tax and 3.876% New York City tax.

The federal income and net investment income tax would be $595,000, and the New York state and local capital gains tax would be $338,150 if they are in the highest brackets.

If the stock is held entirely in the name of the first dying spouse, then all of the stock may receive a new income tax basis equal to its fair market value upon the death of such spouse, unless the deceased spouse received the assets as a gift from the surviving spouse within one year or less of the first death and the surviving spouse inherits it back. This increase in basis is known as a "step-up in basis." Nevertheless, in most situations, it is difficult or impossible to determine which spouse will die first. Further, Internal Revenue Code Section 1014(e) would prevent a step-up in

304. Timothy Barrett, *How Community Property Trusts Can Benefit Married Couples*, KIPLINGER (Sept. 18, 2022), https://www.kiplinger.com/retirement/estate-planning/605227/how-community-property-trusts-can-benefit-married-couples.

basis to the extent that the stock given to the first dying spouse came from the surviving spouse for no consideration and the stock passes to or for the benefit of the surviving spouse as a result of the first dying spouse's death.[305]

Section 1014(e) reads as follows:

> (e) Appreciated property acquired by decedent by gift within 1 year of death
>
> (1) In general. In the case of a decedent dying after December 31, 1981, if—
>
> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
>
> (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.[306]

If the stock is held in joint names (such as tenants by the entireties or joint tenants with right of survivorship), and one spouse dies while the stock is worth $3,000,000, then, immediately after the death of the first dying spouse, the surviving spouse will have the ability to sell the one-half of the stock inherited on the death of the first dying spouse for $1,500,000, and would pay no state or federal tax. However, if the surviving spouse sells his or her one-half of the stock that was held in joint names, such spouse would pay $297,500 in federal income and net investment income tax and $169,075 in New York state and local income tax (one-half of the tax described above, if all of the stock was sold before the death of the first dying spouse).

Instead of holding the stock jointly or placing it into the name of the spouse who may be expected to die first, Harry and Sally can establish a Florida community property trust and have it drafted by the estate planning lawyer for their daughter, who lives in Boca Raton, Florida, and their daughter can serve as trustee.

305. I.R.C.§ 1014(e).
306. *Id.*

On the first death, the surviving spouse can have a $3,000,000 basis in the stock and pay no state, federal, or Medicare tax on the sale.

2. Important Notice for Assets Owned Jointly Before 1977 – The Gallenstein Rule.

Under the case of *Gallenstein v. United States,*[307] a joint asset or account funded by one spouse after 1955 and before 1977 can receive a full step-up in basis upon the death of the donor spouse. It may be best not to transfer such pre-1977 joint assets to a community property trust if the donor spouse has a significantly shorter life expectancy than the other spouse.

3. Full Funding of a Credit Shelter Trust

While the estate tax exemption of $12,920,000 per decedent has made estate tax planning less of a concern for most taxpayers,[308] many factors have caused a great number of married couples to have the need for, and interest in, estate tax planning.[309] The scheduled reduction in the estate tax exemption to one-half of its otherwise inflation-adjusted amount in 2026[310] (which is expected to be approximately $7,000,000), and Bernie Sanders' proposed plan that would have reduced the estate tax exemption to $3,500,000 and the gift tax exemption to $1,000,000,[311] stand to affect more taxpayers. These potential legislative changes, along with significant increases in net worth that have occurred as the result of the recent stock market growth and rising real estate

307. Gallenstein v. United States, 975 F.2d 286, 286 (6th Cir. 1992).

308. *Estate Tax,* IRS, https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax (last visited July 18, 2023).

309. *What is Estate Planning and Why is it Important?,* NATIONWIDE, https://www.nationwide.com/lc/resources/investing-and-retirement/articles/what-is-estate-planning (last visited July 18, 2023).

310. *Prepare for Future Estate Tax Law Changes,* FIDELITY (Feb. 9, 2023), https://www.fidelity.com/learning-center/wealth-management-insights/TCJA-sunset-strategies.

311. Alan Gassman, *Senate Estate and Gift Tax Bill Will Reduce Exemption to $3,500,000 and Take Away Many Opportunities*, FORBES (Mar. 27, 2021), https://www.forbes.com/sites/alangassman/2021/03/27/senate-estate-and-gift-tax-bill-will-reduce-exemption-to-3500000-and-take-away-many-opportunities/?sh=685b93274712.

price, are incentivizing many married couples to learn about and engage in estate tax planning.

One challenge for many couples is how to lock up as much in assets as possible under a credit shelter trust on the first death, when the surviving spouse may have significant estate tax challenges, but the first dying spouse has only approximately half of the assets that can be used to fund a credit shelter trust and the value of such assets are far less than the exemption amount.

Many planners believe that it is fine to leave all assets to the surviving spouse and not make full use of the estate tax exemption of the first dying spouse by maximizing the funding of credit shelter trusts because the surviving spouse will receive the unused estate tax exemption of the first dying spouse under the portability rules if the first dying spouse's estate files an estate tax return in the proper manner. [312]These advisors may not be taking into consideration that one or more of the following issues may arise:

(1) The surviving spouse may remarry and then the new spouse may die, resulting in the portability allowance of the surviving spouse being reduced to whatever is available from the subsequent dying spouse;

(2) The portability allowance is not indexed to grow with inflation or with the growth of assets as would apply under a credit shelter trust;[313] and

(3) The portability allowance does not provide for the surviving spouse to "port" the first dying spouse's unused GST exemption.[314]

For example, let us assume that Harry and Sally have $7,000,000 in personally owned investment assets, a $1,000,000 home, and $3,000,000 in IRAs.

They also receive approximately $150,000 per year in pension income, and their assets are expected to grow at approximately 7.25% a year after taxes and expenses.

312. John Bunge & Jill Mastroianni, *IRS expands "portability" of key estate tax exemption*, HOLLAND & KNIGHT (July 12, 2023), https://www.hklaw.com/en/insights/publications/2022/07/irs-expands-portability-of-key-estate-tax-exemption.

313. *Credit Shelter Trusts and Estate Taxes,* FIDELITY (March 2022), https://www.fidelity.com/viewpoints/wealth-management/insights/credit-shelter-trusts.

314. Jean Gordon Carter & Stephen W. Murphy, *What is Portability for Estate and Gift Tax?* ACTEC, https://www.actec.org/estate-planning/portability-estate-tax-exemption/ (last visited July 18, 2023).

They have a 20-year life expectancy, despite eating a lot of deli food, including corned beef, pastrami, matzo ball soup, potato knishes, and egg creams almost every day.

In 20 years, their net-worth will be approximately $28,382,069.37 so they would like to not only avoid capital gains tax for the surviving spouse but also place as much as possible into a credit shelter trust on the first death.[315]

If Harry and Sally each presently have approximately $4,000,000 worth of assets in a separate revocable trust or $8,000,000 worth of assets in a joint trust that only has half of the assets locked up under a credit shelter trust on the first death, then there can be a significantly higher estate tax on the second death.

Harry and Sally may therefore consider a JEST ("Joint Exempt Step-up Trust") in lieu of a community property trust for their income tax basis and estate planning so that $8,000,000 can be set aside under a credit shelter trust after the first death.

XI. BUT IS THE JEST TRUST SUPERIOR TO THE COMMUNITY PROPERTY TRUST? - TAKE A SERIOUS LOOK AT THIS PLANNING TOOL

The Joint Exempt Step-Up Trust, or the "JEST", is a joint revocable trust established by a married couple. Under a JEST, the first dying spouse has the testamentary power to appoint all of the trust assets to creditors of his or her estate, which causes all assets of the trust to be included in his or her estate for federal tax purposes so that such assets may receive a new fair market value income tax basis under Code Section 1014, and be considered to be the assets of the first dying spouse for purposes of funding a credit shelter trust.[316]

Three Private Letter Rulings (PLRs) and a Technical Advisory Memorandum (TAM) published in 1999 and 2000 support this proposition, although there is some risk that the IRS might not follow these non-precedential pronouncements and take the position that the transfer of assets considered as owned by the

315. Under the Portability rules, the portion of the first dying spouse's $11,700,000 estate tax exemption (or whatever the exemption amount will be at the time of death) can be used by the surviving spouse, but the portability allowance (1) does not go up with inflation; (2) will be lost or replaced if the surviving spouse remarries someone who then dies before the surviving spouse and leaves no portability allowance: and (3) does not provide the same creditor protection for the surviving spouse as having a credit shelter trust funded.

316. *Id.*

surviving spouse to a credit shelter trust might be characterized as a gift by the surviving spouse.[317] One of these Private Letter Rulings was applied where each spouse had a separate Revocable Trust, and each spouse had a Power of Appointment over the assets of the Revocable Trust of the other spouse. This technique can work as well as a JEST, but is often considered to be confusing by clients and many advisors.[318] This risk is ameliorated by the design of the JEST, which contains provisions that cause the assets that were contributed to the trust by the surviving spouse to be held in a separate credit shelter trust of which the surviving spouse is not a beneficiary unless or until such spouse is added by a committee of independent trust protectors serving in a non-fiduciary capacity.[319]

Further, the JEST can be drafted so that the separate credit shelter trust might be deemed as funded by the surviving spouse if considered to be an incomplete gift for gift tax purposes by giving the surviving spouse the power to direct how assets may pass among the spouses' common descendants or otherwise upon death and requiring the surviving spouse's consent to any distribution from such separate credit shelter trust.[320]

The same PLRs and TAM that concluded that a credit shelter trust could be funded with assets considered as owned by the surviving spouse also concluded that those assets would not receive a new income tax basis, based upon the assertion that the arrangement constitutes a gift by the surviving spouse to the first dying spouse immediately before death, that is then inherited by the surviving spouse, thus triggering the Internal Revenue Code Section 1014(e) one-year rule.[321]

The PLRs and TAM, however, failed to point out that while Section 1014(e) applies when an asset is gifted to a decedent who devises it back to the donor upon death, it does not necessary apply

317. Alan Gassman, Christopher Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses – Part 1*, 40 Est. Plan. 3, 3-11 (2013); *see also* Susan L. Racey, *Joint Revocable Trusts*, 20 OHPRLF 77 (2008).

318. *Power of Appointment, Legal Information Institute*, CORNELL UNIV. L. SCH. (June 2022), https://www.law.cornell.edu/wex/power_of_appointment.

319. *Joint Exempt Step-Up Trust,* ULTIMATE EST. PLANNER, https://ultimateestateplanner.com/products/joint-exempt-step-trust-legal-document-form-jest/ (last visited July 18, 2023).

320. H. Zaritsky & Farhad, *Tax Planning for Family Wealth Transfers at Death: Analysis with Forms §4.07[3][b][iii]* (Thomson Reuters/Tax & Accounting 2014, with updates through July 2023) (providing an additional discussion on JESTS).

321. I.R.C.§ 1014.

in a situation where the assets are left to an irrevocable trust that may benefit the donor.

A properly drafted JEST may therefore contain provisions that would make it unlikely or potentially even impossible for the surviving spouse to benefit from the credit shelter trust that is funded with the assets considered to have been held by the surviving spouse. Section 1014(e) should not be implicated if the surviving spouse cannot benefit from assets that he or she is considered to have contributed to the trust, therefore allowing for a step-up in basis as to such assets on the first dying spouse's death. This is why a JEST Trust will typically provide that the surviving spouse will not be a beneficiary of the credit shelter trust established and funded with the assets of the surviving spouse on the first dying spouse's death unless or until any and all other trusts for the surviving spouse have been completely spent, and Trust Protectors acting in a non-fiduciary capacity, or the holder of a power of appointment without a fiduciary duty to exercise it may add the surviving spouse to the Trust. This would typically occur much more than three years after the trust assets may be sold with an assumed full step-up in income tax basis.

As a practical matter, assets held under a JEST trust might be sold to avoid capital gains taxes shortly after the death of the first spouse, and the surviving spouse would not be added to or considered to be a beneficiary of the JEST credit shelter trust unless or until it is clear that the income tax return for the tax year of the sale would not be audited, or that the audit would not be complete.

The JEST is clearly more complicated than the community property trust from the point of view of the drafter and for tax administration purposes, but should allow for the funding of a credit shelter trust from all assets of the JEST.

1. Non-Tax Considerations of Joint Trust Vehicles

Notwithstanding the allure and advantages of the use of community property trusts and JESTs, many married couples will prefer to have a simple joint trust that may be treated as a tenancy by the entirety's vehicle or a simple "joint with full or limited" right of survivorship vehicle. From a fundamental perspective, a joint trust can function essentially as a marital agreement between the spouses that defines the rights, obligations, and restrictions on disposition associated with the assets of the trust. Advisors need to be very careful to explain the options that a married couple has with respect to this.

Many couples will decide to have their most appreciated assets held under community property trusts or JESTs, with less appreciated assets being held under tenancy by the entireties trusts (or as tenants by the entireties outright) to provide creditor protection so that a creditor owed money by only one spouse cannot reach the trust assets.

While nothing in the Florida common law or statutory law prevents trust assets from being held as tenants by the entireties of a married couple, a recent opinion issued by the Middle District of Florida Bankruptcy Court specifically states that "[t]he issue is whether a revocable living trust can own property as tenants by the entireties to exempt it from creditors' claims in bankruptcy cases. The answer is no because the trust cannot meet the unities required for tenants by the entireties ownership."[322] In reaching its decision, the Middle District of Florida Bankruptcy Court cited the 1941 Florida Supreme Court case of *Hunt v. Covington*:

"No persons except the husband and wife have a present interest in an estate by the entireties . . .. It is not subject to partition; it is not subject to devise by will; neither is it subject to the laws of descent and distribution. It is, therefore, an estate over which the husband and wife have absolute disposition and to which each, in the fiction of law, holds the entire estate as one person."[323]

The authors and many others disagree with the Bankruptcy Court Judge's conclusion and do not believe that the Court considered the fact that a married couple could own the beneficial ownership interest of a trust as tenants by the entireties. As a result of the *Givans*[324] case, many advisors will probably place a significant portion of a married couple's assets into a limited liability company owned as tenants by the entireties that may be "payable on the second death" under the Operating Agreement to a joint trust or to separate trusts upon the death of the first dying spouse.

322. *In re* Givans, 623 B.R. 635, 637 (Bankr. M.D. Fla. 2020).
323. Hunt v. Covington, 200 So. 76, 77 (Fla. 1941).
324. *Givans*, 623 B.R at 635.

XII. "STEP RIGHT UP" - WILL A COMMUNITY PROPERTY TRUST WORK?[325]

There is a question as to whether an elective community property arrangement like the Florida Community Property Trust Act will be recognized by the IRS as a legitimate community property arrangement to qualify all trust assets for a fair market value date of death basis step-up under Internal Revenue Code Section 1014(b)(6) on the death of the first dying spouse. The IRS has not formally commented on the efficacy of community property trust arrangements, although well-respected commentators have concluded that it "should qualify."[326] With the warning that this tax treatment is "not absolutely certain," Jonathan Blattmachr, Howard Zaritsky and Mark Ascher in "Tax Planning with Consensual Community Property: Alaska's New Community Property Law" provides extensive discussion of the *Harmon* case and statutory law that exists in this area. [327]

Since Blattmachr, Zaritsky, and Ascher published their article in 1998, the IRS updated its Publication 555 on community property to specifically provide that "[t]his publication does not address the federal tax treatment of income or property subject to the 'community property' election."[328] It is unknown whether the IRS will take a closer look at whether an "opt-in" community property trust will be afforded a step-up in basis to all trust assets in light of the advent of elective community property trust systems, and that Florida has implemented an elective community property trust regime which will open this planning tool to many more married couples who may have family, friends, or advisors in Florida who can serve as trustees to avoid paying trust company fees for a community property trust.

Commentators who urge caution point to the 1944 U.S. Supreme Court decision of *Commissioner v. Harmon*,[329] which involved a married couple who opted into community property treatment under an Oklahoma law that was passed to allow

325. "Step right up, Step right up, Step right up . . . The large print giveth [a]nd the small print taketh away." TOM WAITS, *Step Right Up, on* SMALL CHANGE (Asylum 1976).
326. I.R.C. § 1014 (b)(6).
327. Blattmachr et al., *supra* note 53, at 631.
328. INTERNAL REVENUE SERV., *supra* note 109, at 1.
329. Comm'r. v. Harmon, 323 U.S. 44, 45 (1944).

married couples living there to elect whether to have community property characterization apply to their assets.[330]

Before 1948, married couples could not file joint federal income returns[331], so each spouse would file a separate return and the spouse with more income would be in a higher tax bracket.[332] Married couples living in community property states were nevertheless able to divide their income from community property equally on income tax returns, giving them an advantage over married couples living outside of community property states.[333]

The U.S. Supreme Court held in *Harmon* that the act of electing into the community property regime constituted an "assignment of income"[334] and quoted the 1930 United States Supreme Court case of *Lucas v. Earl*.[335] *Lucas v. Earl* is one of the most famous United States Supreme Court tax cases, and provides that a taxpayer cannot avoid taxation on income by assigning in advance of receipt.[336]

While some read this case to indicate that it may not be possible to elect into community property status to receive tax advantages, the *Harmon* decision is somewhat vague and seems to base its conclusion on the fact that the Oklahoma statute "permits voluntary action which effects a transfer of rights of the husband and wife, the case is governed by *Lucas v. Earl* and other decisions of like import."[337] In essence, the majority opinion distinguished community property treatment applicable by operation of law upon marriage from community property treatment that applies "by contract" such as where an election is made by the married couple.

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330. *Id.*
331. George S. Goodell, *Taxation- Joint Returns and the Revenue Act of 1948*, 32 MARQ. L. REV. 213 (1948) (discussing income splitting provisions of the 1948 tax act).
332. *Id.*
333. *Id.*
334. *See Harmon*, 323 U.S. at 46.
335. Lucas v. Earl, 281 U.S 111, 111 (1930).
336. *See Harmon*, 323 U.S. at 46. "Under Lucas v. Earl an assignment of income to be earned or to accrue in the future, even though authorized by state law and irrevocable in character, is ineffective to render the income immune from taxation as that of the assignor. On the other hand, in those states which, by inheritance of Spanish law, have always had a legal community property system, which vests in each spouse one half of the community income as it accrues, each is entitled to return one half of the income as the basis of federal income tax." *Id.*
337. Blattmachr et al. *supra* note 53, at 626.

Howard Zaritsky has noted that "I think the JEST is a great technique for what it is seeking to do. It is a way to minimize the problems of 1014(e)."[338]

In a well-written dissent to the *Harmon* decision, Justice Douglas noted that the federal income tax law discriminates in favor of community property states and claimed that the Court's distinction between "consensual" and "legal" community property systems had no practical basis and could not be consistently maintained for federal tax purposes.[339] Justice Douglas went on to opine that "[t]he only apparent basis for such discrimination is that the community property systems in the eight states are traditional; that those eight states have a well settled policy; that Oklahoma merely gives its citizens a choice to get under or stay out of its community property system. Yet how can we say that the state which allows husband and wife to revoke or alter its community property system by contract has a more 'settled' policy towards community property than a state which gives husband and wife the choice to invoke its community property system or to keep their marital property on a common law basis? The truth is that there is a wide range of choices in each. But the fact that there is a choice should not be deemed fatal when Oklahoma's case comes before the Court . . ."[340]

The 1958 United States District Court decision of *McCollum v. United States* seems to support the proposition that the 1014(b)(6) step-up in basis will apply to community property created as a result of an election made by the spouses.[341] In *McCollum*, a married couple elected under the then-applicable 1943 Oklahoma law to treat their assets as community property, and in 1945 Oklahoma changed its law to require that all of a married couple's assets had to be considered to be community property.[342] Mr. McCollum died after the community property status became mandatory and Mrs. McCollum took a full step-up

338. Gassman, Crotty & Denicolo, *The Thursday Report- 1.15.15- On the First Day of Heckerling . . .* ,49TH ANN. HECKERLING INST. EST. PLAN. (Jan. 15, 2015), https://gassmanlaw.com/thursday-reports/thursday-report-1-15-15-first-day-heckerling/.

339. *See* Harmon, 323 U.S. at 55–56. The *Harmon* Court distinguished between "Consensual community property," which arises out of contract and "legal community property," which arises by "incident of marriage by the inveterate policy of the state." In this context, inveterate means long established and unlikely to change. *Id.*

340. *Id.* at 55–56. (J. Douglas dissenting).

341. McCollum v. U.S., 2 A.F.T.R. 2d 6170 (N.D. Okla. 1958).

342. *Id.*

in basis for the full value of the community property that existed on Mr. McCollum's date of death.[343] The court allowed the full step-up in basis.[344]

The *McCollum* decision seems consistent with the notion that Internal Revenue Code Section 1014(b)(6) applies to elective community property as well as mandatory community property. Although Oklahoma had a mandatory community property system, by the time the decision was reached, and because the property at issue was acquired before the change of law in 1945, the property would not have been community property under the 1945 Oklahoma community property law, except because of the fact that the McCollum's had previously designated it as community property under the elective system.[345]

Internal Revenue Code Section 1014 was enacted in 1948, only four (4) years after the Supreme Court decision in *Harmon*, and it is, therefore, possible that Congress recognized the issue by enacting Internal Revenue Code Section 1014(b)(6). This is evidenced by the fact that Congress made no mention in the statutory language and provided no legislative history that would distinguish between elective and mandatory community property systems that existed when the statute was updated. Internal Code Revenue Section 1014(b)(6) is very clear that the step-up in basis applies to the surviving spouse's share of community property "held by the decedent and the surviving spouse under the community property laws of <u>any</u> State, or possession of the United States or any foreign country . . . " (emphasis added), without distinction for elective community property laws or without regard to unique characteristics that a State might have with respect to its community property laws (such as creditor protection features).[346]

A 1977 Revenue Ruling discusses the differences between separate property and community property income, and references the *Harmon* case vis-a-vis the issue of whether income generated by the separate property has become community property by agreement between the spouses.[347] The ruling states that "[t]o the

343. *Id.*
344. *Id.*
345. I.R.C. § 1014(b)(6).
346. *Id.*
347. Rev. Rul. 77-359, 1977-2 C.B. 24 (IRS RRU 1977). "Accordingly, where a husband and wife residing in the State of Washington agree in writing that all presently owned

extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns."[348] The Ruling acknowledges that property converted from separate property to community property is community property for federal tax purposes, and makes no mention as to whether the Service will distinguish between elective and mandatory community property systems[349].

Blattmachr, Zaritsky, and Ascher conclude as follows on the step-up in basis tax issues:

Because the Alaska Community Property law's treatment under Internal Revenue Code Section 1014(b) remains untested, a couple seeking a full step-up in basis when the first spouse dies should preferably place all of their assets in the name of the spouse who is expected to die first. Unfortunately, crystal balls are scarce. Moreover, no change in basis occurs when a donor gives property to the decedent within a year of death and then acquires it directly or indirectly.

There are no known cases or audits, so the risk of this being an issue as a practical matter may be quite small. Nevertheless, the issue will have a larger profile on the IRS's radar now that Florida and its citizenry have entered this arena.

For those looking for reassurance, in a June 29th, 2021, Florida Bar Real Property, Probate, and Trust Law Section presentation entitled "An Examination of the New Florida Community Property Trust Act", Travis Hayes and Robert Lancaster stated that "The IRS is silent on the federal tax treatment of property subject to the community property election . . . silence doesn't mean ineffective . . . as it stands to date, Alaska established these in 1998, Tennessee in 2010, and there are no known cases where the IRS has challenged these opt-in community property trusts. And you know, I know from my personal discussions with trustees in

property and all property to be acquired thereafter, both real and personal, will be community property, such agreement changes the status of presently owned separate property and subsequently acquired separate property to community property." *Id.*

348. Rev. Rul. 77-359, 1977-2 C.B. 24 (IRS RRU 1977).

349. *See* Harmon, 323 U.S. at 54.

those jurisdictions, that they've not had any situation where they did not get the basis adjustment either."[350]

An additional concern with respect to Florida's Community Property Trust Act is whether it is possible to have community property when the assets are not 100% accessible to the creditors of one spouse. Because Alaska and South Dakota allow creditors of one spouse to access 100% of the assets held in a community property trust,[351] assets held in community property trusts in those states are treated more like traditional community property than with a Tennessee, Kentucky, or Florida community property trust.[352] Few articles have been written on this subject, and no definitive authority on this issue exists, but it is a possible argument that the IRS could use to support the proposition that Florida's "elective community property" statute does not result in the assets held under the trust being "real community property." Therefore, in the abundance of caution, it may be safer to use an Alaska or South Dakota community property trust for purposes of receiving the Internal Revenue Code Section 1014(b)(6) double stepped-up basis, although the authors do not believe that any such IRS argument would have any merit due to Internal Code Revenue Section 1014(b)(6) not making any distinction between the types of community property laws of the States.

XIII. CONCLUSION

In conclusion, the Florida Community Property Trust Act should be well understood by estate and tax planning professionals based in Florida, or who have Floridian clients or clients with Florida ties, as a potential tool that will benefit married couples who have substantially appreciated assets and would like to avoid federal income tax by being able to sell the assets after the death of the first dying spouse. In addition, estate and tax planners throughout the United States should be somewhat familiar with the various community property trust acts in order to determine

350. Travis Hayes & Robert Lancaster, *An Examination of the New Florida Community Property Trust Act*, FLA. BAR (2008).

351. ABA Section of Real Property, Trust & Estate Law, *An Introduction to Community Property Trusts*, 35-6 PROB. & PROP. (2021).

352. *See* TENN. CODE ANN. § 35-17-105 (2010) (explaining how a community property trust in Tennessee operates); KY. REV. STAT. ANN. § 386.622 (West 2020) (outlining what constitutes a community property trust in Kentucky); FLA. STAT. § 736.1503 (2022) (delineating the requirements for a community property trust in Florida).

which state will be most appropriate for clients for whom the community property trust would be a good fit.

Given that all five states have statutes that are probably effective to provide a full step-up in basis upon the first dying spouse's death,[353] the main criteria may be what family members or advisors, or trust companies would be preferable trustees. A secondary consideration might be whether all assets held under a Community Property Trust are accessible to creditors, such as using a state (Florida, Kentucky, or Tennessee) that does not expose 100% of the community property trust assets to creditors,[354] versus using a state (Alaska or South Dakota) that exposes all of the Community Property Trust assets to creditors.[355]

Perhaps more importantly, the new Act will cause advisors to discuss basis step-up and logistical planning with clients. A great many Florida lawyers suggest that their clients use predominantly one type of arrangement, such as where each spouse has a separate revocable trust, or the spouses share a joint trust that does not provide a full step-up on the first death.[356] Many lawyers still favor joint ownership of assets without using revocable trusts.[357] Well informed clients with similar circumstances will commonly choose different systems based upon their orientation, appreciation of tax planning strategies, and their perception of cost considerations and complexity.

Perhaps most importantly, The Florida Community Property Trust Act is a reminder that one size will not fit all and that married Floridians and other clients should have tailor-made estate plans to better protect and benefit themselves and their families while effectuating their wishes.

353. Sarah Sharkey, *What Is A Step Up In Basis and How Can I Get One?*, ROCKET MORTGAGE (Feb. 22, 2023), https://www.rocketmortgage.com/learn/step-up-in-basis.

354. Joseph M. Percopo, *Understanding the New Florida Community Property Trust,* 96-4 FLA. BAR J. 16 (2022).

355. Jonathan Petts, *What is Community Property?,* UPSOLVE (June 29, 2022), https://upsolve.org/learn/community-property/.

356. *Should You Create Separate Revocable Trusts or a Joint Trust?,* THE LYNCH LAW GROUP (Aug. 27, 2020), https://lynchlaw-group.com/benefits-of-seperate-revocable-trusts-for-married-couples/.

357. Julia Kagan*, Joint Owned Property: Definition, How It Works, Risks*, INVESTOPEDIA (Mar. 14, 2021), https://www.investopedia.com/terms/j/jointownedproperty.asp.

APPENDIX

Comparison of the Five Community Property Trust States

State	Requirements	Creditor Protection	Property Included	U.S.C.s. 1014(b)(6)
Florida	(1) Expressly declares that the trust is a community property trust within the meaning of this part (2) Has at least one trustee who is a qualified trustee, provided that both spouses or either spouse also may be a trustee (3) Is signed by both settlor spouses consistent with the formalities required for the execution of a trust under this chapter. (4) Contains substantially the following language in capital letters at the beginning of the community property trust agreement: The Consequences Of This Community	(1) An obligation incurred by only one spouse before or during the marriage may be satisfied from that spouse's one-half share of a community property trust. (2) An obligation incurred by both spouses during the marriage may be satisfied from a community property trust of the settlor spouses.	All property owned by a community property trust is community property under the laws of the state during the marriage of the settlor spouses.	**36.1511 Application of Internal Revenue Code; community property classified by another jurisdiction.**--For purposes of the application of s. 1014(b)(6) of the Internal Revenue Code of 1986, 26 U.S.C. s. 1014(b)(6), as of January 1, 2021, a community property trust is considered a trust established under the community property laws of the state. Community property, as classified by a jurisdiction other than this state, which is transferred to a community property trust retains its character as

	Property Trust May Be Very Extensive, Including, But Not Limited To, Your Rights With Respect To Creditors And Other Third Parties, And Your Rights With Your Spouse During The Course Of Your Marriage, At The Time Of A Divorce, And Upon The Death Of You Or Your Spouse. Accordingly, This Trust Agreement Should Be Signed Only After Careful Consideration. If You Have Any Questions About This Trust Agreement, You Should Seek Competent And Independent Legal Advice.			community property while in the trust. If the trust is revoked and property is transferred on revocation of the trust, the community property as classified by a jurisdiction other than the state retains its character as community property to the extent otherwise provided by ss. 732.216-732.228.
South Dakota	An arrangement is a South Dakota special spousal trust if 1) one or both spouses in a marriage transfer	Notwithstanding anything contained in § 55-17-9 to the contrary: (1) A provision of a revocable South Dakota	The trustee of a South Dakota special spousal trust shall maintain records that identify which property held	For purposes of the application of § 1014(b)(6) of the Internal Revenue Code of 1986, 26 U.S.C. § 1014(b)(6), as of

	property to a trust, 2) the trust expressly declares that some or all the property transferred is South Dakota special spousal property as provided in this chapter, 3) and at least one trustee is a qualified person. A South Dakota special spousal trust is enforceable without consideration. Both spouses, or either spouse, may be a trustee. The trust must be signed by both spouses. The trust may be revocable or irrevocable. For purposes of this section, a qualified person is any person who meets the requirements of §§ 55-3-41 and 55-3-39, but without regard to whether that person is the transferor.	special spousal property trust does not adversely affect the interest of a creditor unless the creditor has actual knowledge of the trust when the obligation to the creditor is incurred. The interest of a creditor in an irrevocable South Dakota special spousal property trust may be subject to the rights and liabilities of a creditor with respect to transfers under chapter 55-16 as provided in § 55-17-6; (2) A spouse shall act in good faith with respect to the other spouse in matters involving South Dakota special spousal property. The obligation under and effect of this section may not be varied by a South Dakota	by the trust is South Dakota special spousal property and which property held by the trust is not South Dakota special spousal property.	January 1, 2016, a South Dakota special spousal trust is considered a trust established under the community property laws of South Dakota. For purposes of this chapter, the term, special spousal property, means community property for those purposes. Community property as classified by a jurisdiction other than South Dakota transferred to a South Dakota special spousal trust retains its character as community property while in the trust. If the trust is revoked and property is transferred on revocation of the trust, the community property as classified by a jurisdiction other than South Dakota retains its

	4) A South Dakota special spousal trust shall contain the following language in capital letters at the beginning of the trust: The Consequences Of This Trust May Be Very Extensive, Including Your Rights With Respect To Creditors And Other Third Parties, And Your Rights With Your Spouse Both During The Course Of Your Marriage, At The Time Of A Divorce, And At The Death Of You Or Your Spouse. Accordingly, This Trust Agreement Should Only Be Signed After Careful Consideration. If You Have Any Questions About This Trust Agreement, You Should Seek	special spousal property trust.		character as community property to the extent otherwise provided by South Dakota law.

	Independent Legal Advice.			
Alaska	(a) A community property agreement must be contained in a written document signed by both spouses and classify some or all of the property of the spouses as community property. It is enforceable without consideration. (b) A community property agreement must contain the following language in capital letters at the beginning of the agreement: The Consequences Of This Agreement May Be Very Extensive, Including, But Not Limited To, Your Rights With Respect To Creditors And Other Third Parties, And Your	(j) An obligation incurred by only one spouse before or during marriage may be satisfied only from the property of that spouse that is not community property and from that spouse's interest in community property. This subsection does not apply to an obligation described in (b) of this section. (k) An obligation incurred during marriage by both spouses may be satisfied from property of each spouse that is not community property and from the community property.	(h) The trustee of a community property trust shall maintain records that identify which property held by the trust is community property and which property held by the trust is not community property.	N/A

	Rights With Your Spouse Both During The Course Of Your Marriage And At The Time Of A Divorce. Accordingly, This Agreement Should Only Be Signed After Careful Consideration. If You Have Any Questions About This Agreement, You Should Seek Competent Advice. (c) A community property agreement may not adversely affect the right of a child to support.			
Tennessee	An arrangement is a community property trust if one or both spouses transfer property to a trust, that: (1) Expressly declares that the trust is a Tennessee community property trust;	(a) An obligation incurred by only one spouse before or during marriage may be satisfied from that spouse's one-half (1/2) share of a community property trust. (b) An obligation incurred by	(c) All property owned by a community property trust will be community property during marriage.	N/A

	(2) Has at least one (1) trustee who is a qualified trustee whose powers include, or are limited to, maintaining records for the trust on an exclusive or a nonexclusive basis and preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Both spouses or either spouse may be a trustee; (3) Is signed by both spouses; and (4) Contains the following language in capital letters at the beginning of the trust: The Consequences Of This Trust May Be Very	both spouses during marriage may be satisfied from a community property trust of the spouses.		

	Extensive, Including, But Not Limited To, Your Rights With Your Spouse Both During The Course Of Your Marriage And At The Time Of A Divorce. Accordingly, This Agreement Should Only Be Signed After Careful Consideration. If You Have Any Questions About This Agreement, You Should Seek Competent Advice.			
Kentucky	Any arrangement between spouses involving community property shall be considered a community property trust if one (1) or both spouses transfer property to a trust that: (a) Expressly declares that the trust is a Kentucky community property trust that meets the	(1) An obligation incurred by only one (1) spouse before or during marriage may be satisfied from that spouse's one-half (1/2) share of a community property trust. (2) An obligation incurred by both spouses during marriage may be satisfied from a community	All property owned by a community property trust shall be considered community property during marriage and the right to manage and control property that is transferred to a community property trust shall be determined by the terms of the trust.	N/A

	requirements of Sections 1 to 3 of this Act; (b) Has at least one (1) trustee who is a qualified trustee whose powers include or are limited to maintaining records for the trust, on an exclusive or a nonexclusive basis, and preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Both spouses or either spouse may be a trustee; (c) Is signed by both spouses; and (d) Contains the following language in capital letters at the beginning of the trust: The Consequences Of This Trust May Be Very Extensive,	property trust of the spouses		

	Including But Not Limited To Your Rights With Your Spouse Both During The Course Of Your Marriage And At The Time Of A Divorce. Accordingly, This Agreement Should Only Be Signed After Careful Consideration. If You Have Any Questions About This Agreement, You Should Seek Competent Advice.			

Comparison of Traditional Community Property States to
Community Property Trust States

	Traditional Community Property States			
	California	**Texas**	**Alaska**	**Florida**
When do spouses become subject to state community property laws?	When the spouses are married and domicile in the state.	When the spouses are married and domicile in the state.	When the spouses choose to "opt-in" and create a community property trust under Alaska's community property laws.	When the spouses choose to "opt-in" and create a community property trust under Florida's community property laws.
When does the community property regime terminate (causing	Change of domicile, death of spouse, living separate and apart before	Change of domicile, death, decree of divorce or annulment.	Death of a spouse, dissolution, divorce, annulment,	Death of a spouse, dissolution, divorce, annulment,

subsequently acquired assets or future income to no longer be characterized as community property)?	dissolution with no present intent to resume marital relations and conduct evidencing a complete and final break in the marital relationship, legal separation, or judgment of dissolution.		legal separation.	legal separation.
What property is available to satisfy a premarital federal tax obligation assessed against only one spouse?	100% of all community property and all separate property of the liable spouse.	All separate property of liable spouse, 100% of joint management community property, 100% of liable spouse's sole management community property, and 50% of nonliable spouse's sole management community property. If a homestead is involved, contact counsel.	100% of trust assets are exposed to one spouse's creditors	50% of trust assets are exposed to one spouse's creditors
How is post marital income generated from separate property (e.g., rents, dividends, interest) characterized?	Separate property unless a portion is derived from CP time effort and skills. If so, an	Community property.	Separate property unless placed into a community property trust.	Separate property unless placed into a community property trust.

	allocation must be made.			
How does the state characterize appreciation in the value of separate property?	Separate property where appreciation is a "natural enhancement of SP" and spouse has expended a minimum of effort or effort has insignificant value. If spouse's labor or CP funds are used to acquire or improve the SP, a right of reimbursement exists, and it creates a community property interest in the asset.	Separate property. If community property funds or labor are used to acquire or improve the asset, an equitable lien is imposed against the spouse's separate real property, but the character of the separate property is not changed.	Separate property unless placed into a community property trust.	Separate property unless placed into a community property trust.
Does the state recognize common law marriage?	No, but it recognizes a common law marriage legally established elsewhere.	Yes. To qualify, spouses must cohabit in Texas, agree to be married and represent that they are married. Parties to a common law marriage must obtain a divorce or annulment to terminate the marriage.	No, but it recognizes a common law marriage legally established elsewhere.	No, but it recognizes a common law marriage legally established elsewhere.

Does the state recognize some form of domestic partnership as an alternative to marriage?	Yes	No	No	No
Does a domestic partnership under state law create community property rights and obligations?	Yes	Not applicable	Not applicable	Not applicable
Does a deed taken in the name of one spouse as sole and separate property create separate property?	No. Title does not determine the character of the property. It is rebuttably presumed to be community property.	Only if the deed also contains a recital that the consideration was paid from separate funds of that spouse. If so, the property is then presumed to be separate	Yes, but if the property is placed into a community property trust it becomes community property regardless of the title of the property.	Yes, but if the property is placed into a community property trust it becomes community property regardless of the title of the property.
How does the state characterize appreciation in the value of separate property? See paragraph 5 of IRM 25.18.4.13, Mortgage Reduction and Other Tracing Issues, for additional guidance.	Separate property where appreciation is a "natural enhancement of SP" and spouse has expended a minimum of effort or effort has insignificant value. If spouse's labor or CP funds are used to acquire or improve the SP, a right of	Separate property. If community property funds or labor are used to acquire or improve the asset, an equitable lien is imposed against the spouse’s separate real property, but the character of the separate property is not changed.	Separate property unless placed into a community property trust.	Separate property unless placed into a community property trust.

	reimbursement exists, and it creates a community property interest in the asset.			
How does the state characterize property taken by spouses under a deed reflecting that the property is held in joint tenancy?	The property is rebuttably presumed to be a joint tenancy. Factors rebutting the resumption include: If acquired during marriage, if acquired with CP funds, if parties knew the legal consequences of JT vs. CP, if loan proceeds deposited into CP account.	Depends on source of funds used to acquire property. Community property remains CP unless a written agreement to partition is first executed. Otherwise property is CP with a right of survivorship. Property purchased with separate funds may be held as joint tenants, with undivided 1/2 interest being separate property.	Property will be held as joint tenants and considered separate property unless placed into a community property trust, at which point the property will be considered to be community property.	Property will be held as joint tenants and considered separate property unless placed into a community property trust, at which point the property will be considered to be community property.
How does the state characterize property taken by spouses under a deed reflecting that the property is held in tenancy in common?	The property is rebuttably presumed to be separate property. Very uncommon form of ownership between spouses	Community property, unless a written agreement to partition is executed. Property purchased with separate and community funds is owned as tenants in common.	Property will be held as tenants in common and considered separate property unless placed into a community property trust, at which point the property will be considered to be community property.	Property will be held as joint tenants unless placed into a community property trust, at which point the property will be considered to be community property.

Does the state recognize pre or post marital property characterization agreements?	Yes	Yes	Yes	Yes
What are the property characterization agreements called?	Premarital, post-marital, prenuptial or postnuptial agreements.	Premarital and marital or post nuptial agreements.	Premarital, prenuptial, post nuptial, post marital	Premarital, antenuptial, post-marital, prenuptial or postnuptial agreements.
Are property characterization agreements required to be in writing?	Premarital agreements must be in writing. Postmarital agreements need only be in writing if they involve real estate.	Agreements must be in writing.	Agreements must be in writing.	Agreements must be in writing.
Are property characterization agreements valid against creditors?	Yes. Premarital contracts before 1986 required to be recorded. After 1986, no need for recording to be valid. Premarital not subject to fraudulent conveyance laws. Post-marital need not be recorded, but are subject to fraudulent conveyance laws.	Yes, unless existing creditor's rights are intended to be defrauded by agreement.	Yes, unless existing creditor's rights are intended to be defrauded by agreement.	Yes, unless existing creditor's rights are intended to be defrauded by agreement.

Creditor Rights in Community Property States

Traditional Community Property States **Can a post-marital creditor of one spouse reach community property to satisfy the separate debt?**	
Arizona	**No**, a post marriage creditor of one spouse may not seize community property to satisfy the debt. *See, e.g.*, *State ex rel. Indus. Commn. of Arizona v. Wright*, 43 P.3d 203 (Ariz. App. 1st Div. 2002). But a premarriage creditor of one spouse may seize community property to the extent of the value of that spouse's contribution to community property that would have been the spouse's separate property if the spouse had remained single. *Hines v. Hines*, 146 Ariz. 565, 707 P.2d 969 (Ct. App. Div. 1 1985).
California	**Yes.** Cal. Fam. Code Ann. § 910. *See also Lezine v. Security Pacific Financial*, 14 Cal. 4th 56, 58 Cal. Rptr. 2d 76, 925 P.2d 1002 (1996) (illustrating that liability of community property is not limited to debts incurred for benefit of community but extends to debts incurred by one spouse alone exclusively for his or her own personal benefit).
Idaho	**Yes**. *See, e.g.*, *Gustin v. Byam*, 41 Idaho 538, 240 P. 600 (1925); *Williams v. Paxton*, 98 Idaho 155, 559 P.2d 1123 (1976); *Bliss v. Bliss*, 127 Idaho 170, 898 P.2d 1081 (1995) (indicating that in Idaho prenuptial debts of spouses are payable from community property, although there may be egregious circumstances such as unfair dealing that would result in reimbursement to community even if no separate asset was enhanced in value and concluding that absent showing that spouse fraudulently or selfishly depleted community property to preserve separate assets, payment of prenuptial debts of one spouse by means of application of community property would not be recoverable by community).
Louisiana	**Yes**, although the non-debtor spouse may seek reimbursement if a divorce or dissolution occurs. La. Civ. Code Ann. arts. 2345, 2364; *Nicaud v. Fonte*, 503 So. 2d 79 (La. Ct. App. 5th Cir. 1987), writ denied, 506 So. 2d 1227 (La. 1987); *Shel-Boze, Inc. v. Melton*, 509 So. 2d 106 (La. Ct. App. 1st Cir. 1987) (indicating judgment creditor is entitled to satisfy obligation incurred by judgment debtor from wages of debtor's spouse that were community property when garnishment became effective); *Kerico v. Doran Chevrolet, Inc.*, 572 So. 2d 103 (La. Ct. App. 1st Cir. 1990) (holding due process is not violated by seizure of community property to satisfy judgment creditor of one spouse without serving notice on other); *Federal*

	Deposit Ins. Corp. v. Kemp, 766 F. Supp. 511 (E.D. La. 1991) (holding although contract of continuing guaranty is separate debt of guarantor, judgment against guarantor can be satisfied from community property during community property regime).
Nevada	**Yes.** *See, e.g.*, *Randono v. Turk*, 86 Nev. 123, 466 P.2d 218 (1970) (holding spouse's separate debt may be satisfied out of community property). But non-debtor spouse is not liable for separate debts of debtor spouse incurred before marriage. Nev. Rev. Stat. Ann. § 123.050.
New Mexico	**Yes**, but only as to the debtor spouse's one-half interest in community property. N.M. Stat. Ann. §40-3-10. *See also Huntington Nat. Bank v. Sproul*, 1993-NMSC-051, 116 N.M. 254, 861 P.2d 935 (1993).
Texas	**Yes**, but only as to community property under the "sole management" of the debtor spouse or under the "joint management" of both spouses. *See, e.g.*, *In re Estate of Herring*, 983 S.W.2d 61 (Tex. App. Corpus Christi 1998); *Butler v. Butler*, 975 S.W.2d 765 (Tex. App. Corpus Christi 1998).
Washington	**No**, community property is generally insulated from a separate creditor if the separate debt is in contract. *See* Wash. Rev. Code § 26.16.200; *National Bank of Commerce of Seattle v. Green*, 1 Wash. App. 713, 463 P.2d 187 (Div. 1 1969); *deElche v. Jacobsen*, 95 Wash. 2d 237, 622 P.2d 835 (1980). But community property may be reachable by separate creditors if the debt is in tort. *See Haley v. Highland*, 142 Wash. 2d 135, 12 P.3d 119 (2000) (finding that victim of separate tort committed by one spouse can use tortfeasor spouse's one-half interest in community personal property to satisfy separate tort obligation if tortfeasor's separate property was insufficient to satisfy claim).
Wisconsin	**Yes**. *See Schultz v. Sykes*, 638 N.W.2d 76 (Wis. App. 2001) (Judgment creditor of wife had right to proceed against husband in garnishment action as long as husband's wages were properly classified as marital property under Wisconsin law.) *See also* Wis. Stat. Ann. § 766.55 and Wis. Stat. Ann. § 803.045.

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