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Trust and Estate Law

By Jennifer Spitz

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This article discusses 10 factors that should be considered in addressing out-of-state property as part of a well considered estate plan.

Clients residing in Colorado often own property in other states. The property may be a vacation home, rental property, a family farm, mineral interests, a timeshare, or some other asset. If a Colorado client owns property, especially real property, in another state, several issues should be considered in determining how to best integrate that asset into the client's estate plan.

This article addresses 10 estate planning considerations for out-of-state property. It is not an exclusive list of the issues that may arise.

1. Ancillary Probate Versus Avoiding Probate

If probate is opened in Colorado and a personal representative is appointed by a Colorado court, the personal representative does not necessarily have authority over probate assets located in another state. Typically, "ancillary" probate will be required in the other state to establish the personal representative's authority to deal with assets there. Because this will require time and expense that would not be necessary if the out-of-state assets were to pass outside of probate, attorneys should evaluate on a case-by-case basis whether steps should be taken while the client is alive to avoid ancillary probate.

If probate in the other state will not be complicated, ancillary probate may be a viable option. Colorado has a simplified ancillary probate system, titled "Proof of authority,"[1]and many other states have a similar option. Under this system, if a probate matter is not pending in the state where the out-of-state asset is located, probate can be opened in the state of domicile, and the personal representative may file with the court in the ancillary state authenticated copies of the appointment documents. In some situations, ancillary probate may cost less than avoiding probate.

When ancillary probate will be costly and time-consuming, it may be worthwhile for the client to avoid probate by

converting a probate asset into a non-probate asset.

One common way to avoid probate in Colorado and other states is to transfer assets to a revocable trust. The trust can be fully funded to avoid probate or, alternatively, the trust could be funded with just the out-of-state assets, to avoid ancillary probate, with the client relying on Colorado probate and a pour-over will (which adds assets to the trust at death) for the Colorado assets.

A second option to avoid probate is to hold title in joint tenancy or tenancy by the entirety. For example, spouses who intend to leave their assets outright to each other can hold out-of-state property in joint tenancy with rights of survivorship or in tenancy by the entirety (discussed further below) and avoid probate of such property at the first spouse's death. (A different technique would have to be employed after the first spouse dies to avoid probate at the surviving spouse's death.) However, there are drawbacks to holding property as joint tenants with a non-spouse, so titling property in joint tenancy with a non-spouse is rarely the best solution.

A third option to avoid probate is to use a beneficiary deed, which is also known as a transfer-on-death deed. Several states allow for creation of a beneficiary deed,[2] which operates like a payable-on-death designation on a bank account: The deed names a person to receive the property upon the owner's death, allowing the property to pass to the named beneficiary outside of probate. The beneficiary does not have any ownership rights to the property during the owner's life, and the owner can revoke the deed at any time. The beneficiary deed works best when the distribution plan is fairly straightforward; for example, when it names one person as the beneficiary. In contrast, if the deed designates as beneficiaries the owner's "descendants, taking by representation" rather than including the names and ownership percentages for each beneficiary, a title issue may result.

Finally, the property could be transferred to a Colorado limited liability company (LLC) or other business entity. If the property is transferred to a Colorado LLC or other business entity, then neither the LLC nor the underlying asset should be subject to probate in the other state. This technique can be especially useful when there are other benefits to holding the asset in a business entity, such as liability protection,[3] gifting, and succession planning. Keep in mind that if property is transferred to a Colorado business entity, the entity may also need to be registered as a foreign LLC with the state where the property held by the entity is located, in which case annual reports will likely be required in both states.[4]

2. State Estate Tax

Colorado does not currently impose an estate tax or an inheritance tax,[5] but close to 20 states impose these taxes.[6] A client who re sides in Colorado and owns property in a state that imposes state estate tax or inheritance tax may be subject to that tax. The techniques discussed above to avoid ancillary probate, such as transferring the out-of-state asset to a revocable trust, do not necessarily avoid state estate tax.

One of the challenges with planning for other states' estate taxes is that tax systems vary by state. Some states impose an estate tax that operates similar to the federal estate tax but may have a different exclusion amount than that offered under the federal tax system. For example, in Oregon, the exclusion amount is $1 million.7 Other states impose an inheritance tax whereby the rate of tax is determined by the relationship of the decedent to the recipient. For ex ample, in Nebraska, there is a zero inheritance tax rate on property passing to a spouse, 1% to "immediate relatives," 13% to "re mote relatives," and 18% to other recipients.[8]

If a client owns property in another state, the planner should determine whether that state imposes an estate tax. If it does, the next step is to analyze whether state estate tax will be due. For ex ample, if the total value of the client's estate is below the state's exclusion amount, state estate tax will not be due and therefore it may not be necessary to take any steps to plan with state estate tax in mind. If state estate tax will be due, planning options should be considered to reduce or eliminate the tax due.

One option to eliminate estate tax in another state for a Colorado resident is to transfer the property to a Colorado business entity. Real property in a state that imposes estate tax (e.g., New York) could be transferred to a Colorado LLC or other business entity, thereby converting the property to intangible property, which may avoid state estate tax if the

client is a Colorado resident. Accordingly, transferring the out-of-state property to an LLC or other business entity may be preferable to transferring the property directly to a revocable trust when state estate tax is a consideration. However, the state where the real property is located may still tax the underlying real estate if the business entity is a single-member LLC or if the business entity lacks a business purpose.[9]

Another option to eliminate state estate tax is to gift the out-of state assets to an irrevocable trust or outright to the next generation. Few states impose a gift tax; however, federal gift tax and other implications must be considered before gifting an asset.

Planners should also consider taking advantage of the state estate tax exclusion amounts for each spouse. Few states offer portability for state estate tax purposes.[10]Because so few states allow portability for the state exclusion amount, to take advantage of each spouse's state estate tax exclusion amount, it may be advisable to leave the first spouse's ownership interest in out-of-state assets (located in states that impose estate tax) to a bypass trust that is not includable in the surviving spouse's estate. Otherwise, if the state does not allow for portability, the use of the first spouse's state estate tax exclusion amount would be wasted if the asset passes outright to the surviving spouse. This strategy is similar to traditional planning for federal estate tax avoidance and reduction used prior to portability.

State estate tax can operate in surprising ways. One potential pitfall to consider is that state estate tax may be due at the first spouse's death even with a marital deduction plan. If the estate plan directs that assets using the first spouse's federal estate tax exclusion amount pass to a bypass trust (in a manner that does not qualify for the marital deduction), with the balance passing outright to the spouse, then the bypass trust may be funded with up to $5.45 million.[11]If the first spouse has assets in a state that imposes state estate tax, and the exclusion amount is lower than the federal exclusion amount, state estate tax could be due on the first spouse's death depending on the value of the out-of-state assets and the total estate.

Another potential pitfall to consider is that state estate tax may be due when out-of-state assets are fairly nominal. Estate tax may be due from the estate of a Colorado resident even if the value of the property owned by that resident in another state is less than the state exclusion amount offered by that state. This result can occur when the decedent's total estate exceeds the state exclusion amount. The state imposing state estate tax may calculate the estate tax on the entire estate and then pro-rate the amount of tax based on the value of the property located in that state.[12]

3. State Income Tax

State income tax may present planning opportunities, or pitfalls, particularly with respect to irrevocable trusts, which may apply for assets located in Colorado and elsewhere. The following discussion pertains to non-grantor trusts. Grantor trusts, which have different tax reporting requirements and implicate different planning considerations, are not discussed here.

States use different methods to determine whether a trust is subject to a state's income tax as a "resident trust." Colorado taxes trusts as resident trusts if the trust is administered in Colorado.13 In contrast, other states consider a trust to be a resident trust if the grantor resided in the state when the trust was created or when the grantor died.14For example, Illinois employs the latter rule.[15]

For clients who are Colorado residents, state income taxation can be avoided, except as to state source income such as rental in come or mineral royalties, if the client transfers property to an irrevocable trust and the trustee administers the trust in another state that either does not impose income tax (such as Wyoming), or taxes trusts based on the state where the grantor resides when the trust is created (such as Illinois). The trust escapes state income taxation in this situation, except as to state source income, because the trust is not administered in Colorado. If, for example, the trustee administers the trust in Illinois, Illinois will not tax the trust as a resident trust because the grantor does not reside in Illinois.

While there are opportunities to reduce or eliminate state in come tax by careful selection of the trust's situs, there are also states to avoid. For example, California imposes a higher income tax rate than many states—as high as 13.3%—and

it taxes trusts when either the trustee or non-contingent beneficiary resides in California.16Accordingly, a Colorado resident creating an irrevocable trust should consider avoiding naming a California trustee. Even if cotrustees are named, if one trustee is a California resident, a portion of the trust will be subject to California income tax.[17]

4. Other Taxes

In addition to state estate tax and state income tax considerations, there may be other relevant local or state taxes to consider. These taxes could present a drawback to implementing some of the options to avoid probate discussed above.

For example, in some places a tax on the transfer of property applies if property is retitled, such as retitling to avoid probate. An example of such a tax is the real estate transfer tax imposed by the Town of Vail on transfers of real property.18There are several ex emptions to the tax, but documentation must be submitted to the Town of Vail to establish that an exemption applies.[19]

In California, Proposition 13 should be considered before transferring property in that state. Proposition 13 limits the annual in crease in the assessed value of real property for property tax purposes.[20]Under Proposition 13, property is reassessed when there is a "change in ownership." There are various exceptions to the meaning of "change in ownership." To avoid an inadvertent reassessment of the property, the change in ownership rule and the exceptions should be analyzed before undertaking a transfer of the property.

5. Community Property

Although Colorado is not a community property state, spouses residing in Colorado may own community property, including community property in other states. One of the advantages of community property is that the entire asset receives a new basis at the first spouse's death.[21]In contrast, when spouses co-own noncommunity property, only the deceased spouse's ownership interest receives a new basis at that spouse's death.22Accordingly, it can be useful to preserve community property.

The laws of community property states vary; thus, each state's laws must be reviewed on a case-by-case basis. For example, states differ on whether income from and appreciation on separate property is treated as community property.[23]

If a client holds an out-of-state asset that is community property and the intent is to preserve its community property nature, it is important to consider how best to title the asset to preserve its community property nature. The laws of the community property state may specify how title must be shown on the deed to create or preserve community property.[24]Therefore, if the intent is for the out-of-state asset to be community property, it is important to ensure that the asset is titled in a manner consistent with that in tent. Historically, holding title as joint tenants was inconsistent with treating the asset as community property. However, several states enacted legislation to allow community property to be held in joint tenants with rights of survivorship.[25]For example, in California, title should be held as "community property with right of survivorship" when the intent is to give rights of survivorship (as with joint tenancy) while preserving the community property nature of the asset.[26]

Rather than keeping property in the clients' own names, the property could be transferred to a trust. Joint trusts are commonly used to hold community property. To avoid commingling community property with non-community property, which could lead to difficult tracing problems, the community property assets could be placed in a joint trust, with all other assets held in the clients' own names or in separate revocable trusts. One option to coordinate the joint trust with the rest of the plan is to provide that the joint trust terminates at the first spouse's death, with a one-half interest passing to the deceased spouse's estate (or that spouse's revocable trust) and the other one-half interest passing to the surviving spouse's estate (or that spouse's revocable trust). With this approach, the community property asset remains segregated, but there is one cohesive estate plan at death.

6. Tenancy by the Entirety

Tenancy by the entirety is a form of co-ownership available to married couples whereby property is deemed to be held by a single, individual marital unit. Tenancy by the entirety ownership provides protection for the property from the creditors of one spouse.[27]This creditor protection feature makes this form of ownership a valuable creditor protection tool.[28]The creditor protection benefits may be available for property in a state that allows for tenancy by the entirety ownership, even though the couple resides in another state.[29]

If clients own property in a state that allows property to be held in tenancy by the entirety, this option should be considered. As with community property, the laws of the particular state must be followed to create a tenancy by the entirety. Historically, title needed to be held in both spouses' names to create tenancy by the entirety property, but some states have enacted legislation to allow property held in a trust to have the protections offered by tenancy by the entirety ownership.[30]

Tenancy by the entirety is available in at least 25 states,[31]but not in Colorado.[32]

7. Logistics of Transfers (and Potential Glitches)

If retitling out-of-state property is advisable, such as by transferring title to a revocable trust or business entity, a variety of considerations apply to the logistics of the transfer depending on the type of transfer and the particular state laws involved. Consent to the transfer may be required in advance, for example, if there is a right of first refusal attached to the property. Also, some homeowner's associations have restrictions on transfers.

In the case of timeshares, an ownership change may require more than just deeding the property. The timeshare company will usually require that the transfer also be processed through their system pursuant to the company's protocol, for which a fee may be charged by the timeshare company.

If the property is subject to a mortgage or deed of trust, a transfer may give the lender the right to accelerate the loan. The provision of the mortgage or deed of trust granting this right to accelerate the loan is commonly referred to as the "due on sale" clause. The Garn-St. Germain Depository Institutions Act of 1982 prevents a lender from accelerating a loan in the case of certain transfers of residential real property.[33]However, the Act needs to be carefully considered case-by-case and will not prevent the due on sale clause from applying in all cases, such as transfers of non-residential property or a transfer to an LLC or other business entity. The client may want to obtain the lender's consent prior to the transfer to avoid the risk of the lender accelerating the loan.

If property is transferred, such as to a revocable trust or a business entity, the new owner may not have coverage under the title insurance policy that the client obtained when the property was purchased. If property has been in a family for decades, there may not be any title insurance. If there is title insurance, consider whether the property can be conveyed in a way that maintains the title insurance coverage; alternatively, consider purchasing new title insurance or adding the new owner to the existing policy.[34]

Before undertaking a transfer of out-of-state property, an attorney licensed to practice law in that state should be retained to ad vise on the applicable state law implications and the effectiveness of the plan for handling the assets in that state, and to assist with any transfer of the property.

8. Mineral and Water Rights

Recording a deed to transfer out-of-state property may be only one step in transferring all of the client's ownership interest in an out-of-state asset. For example, if mineral rights are transferred and there is current oil and gas production, the oil and gas company will probably require new division orders before issuing royalties to the new owner.

If the property includes water rights, those rights must be re titled. Listing the water rights in the deed may not be sufficient; for example, if the water rights include ditch stock, a new stock certificate will probably need to be issued by

the ditch stock company.

9. Transfers to a Trust

In Colorado, it is acceptable, and arguably preferable, to transfer title to the name of a trust (e.g., "The John Smith Trust") rather than transferring to the trustee (e.g.,"John Smith as trustee of the John Smith Trust").[35]However, in other states it may be necessary or advisable to take title in the name of the trustee.[36]

10. Domicile

This article contemplates planning for clients domiciled in Colorado. If the client spends significant time in another state, a question may arise about whether the client is in fact domiciled in Colorado. This question can be important for determining:

- where the client should file state income tax returns. For ex ample, if the client spends time in Colorado and Wyoming (which does not impose state income tax), is the client a Colorado resident and therefore required to file a Colorado income tax return as a resident? Alternatively, if the client is a Wyo ming resident, the client would only file in Colorado if the client has Colorado source income, in which case the client would file as a nonresident and only pay state income tax on the Colorado income.37
- which states will impose income tax on a trust created by the client. As discussed above, the client's domicile can dictate whether a lifetime irrevocable trust or testamentary trust is subject to income tax in a particular state.
- whether state estate tax will be due. If the client is domiciled in a state that imposes state estate tax, the client's entire estate will be subject to state estate tax, rather than just the property located in that state.
- which state's laws apply to non-tax matters, such as determining which state's intestacy laws apply, and which laws govern the construction of the client's will and trust, absent specific directions.

Determining which state is the state of domicile is not always a simple matter, especially when the client has significant contacts with more than one state. Domicile is not necessarily determined by counting the number of days spent in each state.

Most states follow the common law definition of domicile. *Black's Law Dictionary* defines "domicile" as follows:

> The place at which a person has been physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and re main even though currently residing elsewhere.[38]

Sorting out which state is the state of domicile requires a case by-case analysis. The relevant factors include the place of homes, family, business, and social affairs, and documentation showing an address or domicile, such as licenses, voter registrations, vehicle registrations, bank statements, and estate planning documents.[39]

Conclusion

Planning for a client's out-of-state property is just one consideration in an estate plan, but it can be an important one. Thoughtful planning for out-of-state assets can help smooth the transfer of those assets at death and minimize taxes and other costs.

Notes

1. CRS § 15-13-204.

2. Colorado is one of the states that allow for beneficiary deeds. CRS §15-15-401 et seq.

3. There may be little or no liability protection with a single-member LLC. See, e.g., *In re Albright*, 291 B.R. 538 (Bankr.D.Colo. 2003).

4. For a general list of the powers that can be exercised by non-registered entities in each state, see the 50-state survey, published by Lexis Nexis, "Corporate Law—Foreign Corporations: Foreign Corporations" (Dec. 2015).

5. CRS § 39-23.5-103 imposes a state estate tax, but it is tied to the state death tax credit under IRC § 2011, which was repealed; therefore, Colorado effectively does not currently impose an estate tax.

6. For a list of the states that impose state estate tax or inheritance tax and a brief summary of these taxes, see the State Death Tax Chart at www.mcguirewoods.com.

7. Or. Rev. Stat. § 118.010.

8. Neb. Rev. Stat. §§ 77-2004 to 77-2006.

9. See, e.g., New York State Dept. of Tax. and Finance, Advisory Opinion TSB-A-08(1)M (Oct. 24, 2008).

10. Hawaii offers portability. Haw. Rev. Stat. § 236E-6. Maryland will also offer portability for decedents dying on or after January 2, 2019. Md. Code Ann., Tax-Gen § 7-309.

11. The federal estate tax exclusion amount is $5.45 million in 2016, and is indexed for inflation. IRC § 2010(c).

12. Bart, "Planning in Decoupled States," SP037 ALI-ABA 359 (2009).

13. CRS § 39-22-103(10) (defining "resident trust").

14. Nenno, "Let My Trustee Go! Planning to Minimize or Avoid State Income Taxes on Trusts," Heckerling Institute on Estate Planning, University of Miami School of Law ¶ 1501.2 (2012).

15. 35 Ill. Comp. Stat. 405/2; Nenno, *supra* note 14 at ¶¶ 1501.3, 1501.4.

16. Cal. Rev. & Tax. Code § 17742; Nenno, *supra* note 14 at ¶¶ 1501.6, 1501.7; 1-13 California Guide: Planning For The Elderly § 13.02 (Lexis Nexis, 2015).

17. Cal Rev. & Tax. Code § 17743.

18. Vail, Colorado Town Code, Title 2, Chapter 6.

19. *Id*. at § 2-6-6.

20. Cal. Const., art. 13A

21. IRC § 1014(b)(6).

22. Johns et al., eds., *Colorado Estate Planning Handbook*, § 29.4.4 (CLE in Colorado, Inc., 6th ed.).

23. *Id*.at § 29.2.2.

24. *Id*.

25. *Id*.at § 29.2.7.

26. Cal. Civil Code § 682.1.

27. Nelson, “Asset Protection & Estate Planning—Why Not Have Both?” Heckerling Institute on Estate Planning, University of Miami School of Law ¶ 1704 (2012).

28. Although tenancy by the entirety offers significant creditor protection, there are cases holding that the IRS and other “super creditors” may be able to reach the property even if only one spouse is liable for the debt. Id.at ¶ 1704.3.

29. *Id*.at ¶ 1704.4[A].

30. See, e.g., Tennessee 35-15-510; Haw. Rev. Stat. § 509-2.

31. Nelson, *supra* note 27 at ¶ 1704.1.

32. CRS § 38-31-201.

33. 12 USC § 1701j-3 (Garn-St. Germain Depository Institutions Act of 1982); Johns, *supra* note 22 at § 22.5.5.

34. *Id*.at § 22.5.3 (discusses the possible use of a general warranty deed to preserve title insurance).

35. Ambler, “Title to Colorado Real Property Held in Trust,” 31 The Colorado Lawyer85 (May 2002), www.cba.cobar.org/tcl/tcl_articles.cfm? articleid=1602.

36. Wolf, ed., 14-81*A Powell on Real Property*§ 81A.04 (LexisNexis Matthew Bender, rev. 1999).

37. CRS § 39-22-404.

38. Brogan, Jr. and Ross, “Changing State of Domicile Is Easier Said than Done,” 39 Est. Plan.3 (July 2012).

39. *Id*.Some states do have objective criteria for determining domicile for state income tax based on the number of days the person spends in the state.