

ENTERING THE CRESCENT OF ENLIGHTENMENT: A QUICK TOUR OF COMMUNITY PROPERTY'S UTOPIAN WORLD

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I. Basics of Community Property, Briefly

A. Jurisdictions

Community property law governs the interests of a husband and wife in property acquired during marriage in a community property state. The community property states are Alaska (elective), Washington, California, Idaho, Nevada, Arizona, New Mexico, Louisiana and... Wisconsin (the only state to adopt the Uniform Marital Property Act, and where community property is referred to as "marital property").²

B. History

Community property is a code law legacy of historical French (Louisiana and Wisconsin) and Spanish /Mexican (everywhere else) control or influence over portions of the United States.³ The main source of community property is the 1848 Treaty of Guadalupe Hidalgo that brought an end to the Mexican-American War (known in Mexico as the *War of North American Invasion*), by which Mexico ceded California, Nevada, Utah, most of Arizona, and parts of New Mexico, Colorado and Wyoming, three years after the United States had annexed Texas. The Mexican delegation negotiated for the continuation of community property form of marital ownership in areas heavily settled by Mexicans, in part to protect Mexican women who owned real property in the annexed territories (at the time, the real property of a married U.S. women became the property of her husband).

An obscure fact: During the 1940's several common law states⁴ converted to community property regimes to take advantage of the opportunity of splitting income between husband and wife, which existed only in community property states prior to the

¹ This outline is partly a digest of several outstanding sources, including Reineke, *Community Property Issues for Noncommunity Property Professionals*, Chicago Estate Planning Council (May 2003); Katzenstein, *What Every Community Property Estate Planning Lawyer Should Know About Separate Property*, 2003 UCLA/CEB Estate Planning Institute (May 2003); Featherston, *A Trusts and Estates Lawyer's View of Texas Marital Property Law*, State Bar of Texas 29th Annual Advanced Estate Planning and probate Course (2005); and Moore and Moore, *The Importance of Community Property in an Age of Increased Migration*, ABA 10th Annual Spring CLE and Committee Meeting (1999).

² Looking at the states on a map, the states might appear as a crescent starting with Washington and following the western coast and border to Louisiana (and replacing Oregon with Wisconsin). The author has dubbed this "The Crescent of Enlightenment™."

³ The community property system having been introduced by the Visigoths into present-day Spain and France in the 5th century.

⁴ Michigan, Nebraska, Oklahoma, Oregon, Pennsylvania and Hawaii.

Revenue Act of 1948.⁵ The effort was awkward at best, and doomed to failure by repeal or, in the case of Pennsylvania, by being declared unconstitutional. The Pennsylvania Supreme Court summed the effort up nicely:

It may be stated at the outset that the manifold intricacies of the problems here involved arise largely by reason of the fact that the Community Property Law emanates, in its fundamental concepts, from Spanish sources, and the present attempt to engraft it upon our own system necessarily results in fundamental conflicts with principles of the common law centuries old... It is obvious that the Community Property Law is exotic with respect to both our substantive and procedural law. It represents “a concept of property that is entirely alien and foreign to that of the common law as to the conjugal relationship and marital rights in property.”⁶

On top of its inherent *exoticness*, there is, unfortunately, no uniform community property law. Each state has its own version of community property law, which can result in radically divergent results. For example, in Texas (and other states), income on separate property is generally community property. This is a startling concept to a California or Washington practitioner.

C. What is Community Property?

Community property is usually defined in the negative: Community property is all property owned by a married couple⁷ that is *not* separate property. Separate property, *generally*, means all property owned prior to marriage; property acquired by a spouse by gift, bequest or inheritance; and as otherwise agreed.⁸ Wages are classic community property, consistent in every jurisdiction. Generally community property refers to property that was acquired while the married couple resided in the community property state.

Texas employs its own nomenclature, based on its concepts of “special community property” and “joint community property.” These concepts are utterly foreign to practitioners in other community property states.

California, Texas, Washington and Nevada permit married persons to hold title as “community property with rights of survivorship,” which, as the name implies, is community property in all respects that passes to the surviving spouse upon the death of the first spouse.

⁵ P.L. 80-471, 62 Stat. 110.

⁶ *Wilcox v. Penn Mut. Life Ins. Co.* (Pa. 1947) 55 A.2d 521, 524 (quoting DeFuniak, *Principles of Community Property*, vol. 1, p. 4, §2.

⁷ For purposes of this outline, references to a “married couple” refer to a marriage between a man and a woman. In California, community property law applies to same sex marriages and domestic partnerships. Special conflicts of law and other issues related to same-sex marriages and domestic partnerships are beyond the scope of this outline.

⁸ See, e.g. Cal. Fam. Code, § 770.

D. Ownership Interest

Each spouse has a present, equal, undivided one-half interest in all community property.

E. Death

At death, the deceased spouse has testamentary rights to dispose of one-half of the community property.⁹ Spouses may agree to divide their community interests in the aggregate, rather than a pro-rata division of every asset.¹⁰

If a spouse dies intestate, the states differ in the share that automatically passes to the surviving spouse. For example, if a spouse dies with children surviving who are not the descendants of the surviving spouse, the deceased spouse's one-half share of the community will pass, in Texas, to the decedent's descendants,¹¹ but, in California,¹² to the surviving spouse.¹³

F. Divorce

1. California, Louisiana, New Mexico: Each spouse is entitled to one-half of the community. Whether the community includes quasi-community property depends on the state.
2. Texas, Washington and others: community property (in Texas, this includes including quasi-community property) is divided equitably.

G. Characterization

Characterization of property as separate or community becomes murky in areas such as the appreciation of separate property during marriage, commingling of separate and community, and re-investment of the proceeds of the sale of separate property.

1. Title

- a) Generally, in determining the character of property, title does not control.¹⁴ Rather, it is the *time of acquisition* (was the couple

⁹ See, e.g., Cal. Prob. Code, § 100(a).

¹⁰ See, e.g., Cal. Prob. Code, § 100(b).

¹¹ Tex. Prob. Code, §§ 43 and 45.

¹² And Idaho, New Mexico, Nevada and Washington.

¹³ Cal. Prob. Code § 6401(a).

¹⁴ For example, in Texas, the fact that an asset is held in one spouse's name only, or is in the sole possession of a particular spouse, is not determinative of its marital character and only raises a presumption that the asset is subject to that spouse's sole management and control while the community presumption dictates it is presumptively community. Texas Fam. Code, § 3.104. However, while in California it is presumed that title reflects the ownership (Cal. Evid. Code § 662), this presumption can be overcome rather easily in the community property context. See, e.g., *Jaegel v. Hohanson* (1906) 148 Cal. 695 (property

married at the time?) and *the source of funds* (was separate property, *or the credit*, of one spouse used to acquire the property?) that controls.

b) Holding title as “joint tenants” in a community property state has had different meanings, from time to time. For example, in California:

- For bankruptcy purposes, where spouses take title as joint tenants, each holds his or her interest as separate property;¹⁵
- For divorce law purposes, joint tenancy property is considered community property¹⁶ – however a spouse is entitled to the return of the actual contribution (but not the appreciation thereon) he or she made to the joint tenancy;¹⁷
- For estate tax (and basis step-up) purposes, joint tenancy is not treated as community property, even if the asset was acquired with community property;¹⁸
- For purposes of disposition at death, joint tenancy property is treated as passing to the surviving joint tenant upon the death of the deceased joint tenant, as the survivor’s separate property.

2. Income Accruing from Separate Property

a) Majority (“American”) Rule: In Arizona, California, New Mexico, Nevada, and Washington, income accruing from separate property is separate property.

b) Minority (“Civil”) Rule: In Texas, Louisiana, Wisconsin and Idaho, income from separate property is community property.

- Exception to Minority Rule: In Texas (and perhaps other states), if one spouse gives separate property to his or her spouse, the income on that separate property is presumed to be separate.¹⁹

3. Property Acquired With Community Property

Property acquired with community property, in whole or in part, is community property, unless a non-community component can be traced.

shown to be in name of one spouse determined to be community property); *In re Marriage of Haines* (1995) 33 Cal.App.4th 277 (quitclaim deed executed as a result of undue influence set aside).

¹⁵ *In Re Pavich*, 191 Bank.Rptr. 838 (Bankrtcy.E.DCal. 1996).

¹⁶ Cal. Fam. Code, § 2581.

¹⁷ Cal. Fam. Code, § 2640.

¹⁸ *L. Bordenave v. U.S.*, 150 F.Supp. 820 (N.D. Cal. 1957).

¹⁹ Texas Fam. Code, § 3.005

4. Tracing

Assets acquired during marriage with separate funds, or with the proceeds of the sale of a separate asset, are separate property. However, these assets must be clearly traceable to the original separate property.

5. Commingling

Because of the strong presumption of community property, if adequate records are not, separate property may morph into community property if it is commingled with community property. If commingling makes the tracing of separate property impractical, it will become community property. In California, commingled funds are presumed to be community property, unless the aggrieved party can directly trace the source of funds to separate property.²⁰

6. Rights of Reimbursement

a) Where a spouse applies property to the satisfaction of a debt, a right of reimbursement may arise. For example, in California, unless a written transmutation agreement is entered into:

(1) If community property is used to pay a separate property debt without the consent of the other spouse, the community is entitled to reimbursement from the debtor spouse's separate property.²¹

(2) If separate property is used to pay for the necessities of life of the person's spouse, if community property of the marriage or the separate property of the person's spouse was otherwise available to pay for those necessities, a spouse is entitled to reimbursement for separate property so spent.²²

(3) If community property is used to pay child support of a married person that arises out of a prior marriage when that person had separate property available for that purpose, the community is entitled to reimbursement.²³

(4) If separate property is used to pay a community debt or to acquire or improve community property, the spouse

²⁰ *In re Marriage of Braud*, 45 Cal.App. 4th 797 (1995).

²¹ *In re Marriage of Hebring* (1989) 207 Cal.App.3d 1260 (1989).

²² Cal. Fam. Law Code § 914(b).

²³ Cal. Fam. Law Code § 915(b).

whose property is so used is entitled to reimbursement where the couple separates or divorces.²⁴

b) A right of reimbursement also arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor.

(1) In California, if the increase in value of "separate" property results from "community" effort during the marriage, a portion of that asset will be considered community.²⁵

(2) Other states' approaches vary widely. In Washington, if a spouse provides services to a separate property business the business will become entirely community. In Texas, under similar facts, the community is only entitled to reimbursement for uncompensated labor.

c) Some jurisdictions treat property acquired under an installment contract executed prior to the marriage and funded partly with community property as part community and part separate in proportion to the amount of different funds used.²⁶ Elsewhere, such property may retain its character at the time of the contract (or at the time the right was completely perfected), and the community will have a right of reimbursement.²⁷

7. Life Insurance

a) In California, proceeds from any type of policy will be allocated between separate and community property in proportion to their contributions to the premiums.²⁸

b) In other states, characterization of proceeds depends on whether the policy is whole life or term.

²⁴ Cal. Fam. Law Code § 2640.

²⁵ This portion is determined in one of two ways. Under *Van Camp v. Van Camp* (1921) 199 P. 885, 53 Cal.App. 17, the value of the spouse's services to a separate property business asset is to be deemed community, and the remainder of the asset is separate. Under *Pereira v. Pereira* (1909) 103 P. 488, 156 Cal. 1, a "fair return" is allocated to the separate property, and the balance of the asset's value becomes community.

²⁶ *In re Estate of Dougherty* (1947) 27 Wash. 2d 11 (for real estate mortgage, source of down payment, fixed character of that pro rata portion, and nature of credit pledged determines the remainder regardless of source of later funds).

²⁷ *Allen v. Allen* (1908) 101 Tex. 362 (real estate); *Welder v. Lambert* (1898) 91 Tex. 510 (contract to acquire land); *Goddard v. Reagen* (1894) 8 Tex. Civ. App. 272 (time of acquisition determines character).

²⁸ *Biltoft v. Wooten* (1979) 96 Cal.App.3d 58.

(1) For example, Washington applies a “risk payment” theory for term insurance, whereby ownership of the policy (and the proceeds) follows the source of premium payment.

(2) Arizona, Idaho and New Mexico would probably apply the same approach as Washington.

(3) As to permanent insurance, Arizona, Louisiana, New Mexico and Texas would characterize the nature of the policy and its proceeds based on the “inception of title” rule, which looks at the character of the policy at inception. If the purchaser used community funds to pay premiums on a separate property policy, the community would have the right to reimbursement for its contribution.

H. Liabilities

The law between community property states varies widely in the context of creditors. For example:

1. Texas. A spouse’s separate property is not subject to the liabilities of her spouse.²⁹ A spouse’s “special community property” is not subject to any of the liabilities incurred by the other spouse prior to the marriage or any non-tortious liabilities of the other spouse during marriage.³⁰ A spouse’s separate property and “special community property” and the spouses’ joint community property.
2. California. In California, except as otherwise expressly provided by statute, the community estate is liable for a debt incurred by either spouse before or during marriage, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.³¹ Separate property is subject to creditor claims only of the owner of the separate property.³²
3. Arizona. Under Arizona law, all debts incurred during marriage are, in general, presumptively community debts in the absence of clear and convincing evidence to the contrary.³³ Arizona law permits a creditor on a premarital obligation to reach the debtor spouse's interest in the community property.³⁴

²⁹ Tex. Fam. Code, § 3.202(a)

³⁰ Tex. Fam. Code, § 3.202(b)

³¹ Cal. Fam. Code, §§ 297.5 and 910.

³² Cal. Fam. Code, § 913.

³³ *Schlaefler v. Financial Management Services, Inc.* (2000) 996 P.2d 745 (medical debt incurred during marriage).

³⁴ Ariz. Rev. Stat. Ann. § 25-215(B) (2000).

4. Washington. If a creditor holding a separate debt arising prior to the marriage reduces the claim to judgment within three years, he or she may reach the earnings during marriage of the debtor spouse.³⁵

I. Quasi-Community Property (aka Quasi- Marital Property)

Quasi community property refers to the *separate property* of a spouse acquired while the spouses were not residing in the community property state, but would have been community property had they resided in the community property state at the time of acquisition.³⁶ Quasi community property applies upon divorce and/or at death, depending on the state. The purpose is to protect a spouse who has moved from a common law state to a community property state, preserving the elective share the spouse would have been entitled to had the couple not moved to a community property state. Note that for inheritance purposes, real property situated out of the state cannot be quasi-community property.

1. Divorce

- a) Texas. Quasi-community property, while not divisible, is treated as part of the community for purposes of equitable division upon divorce.

- b) California,³⁷ Arizona,³⁸ New Mexico,³⁹ Idaho, among others: Upon divorce quasi-community is considered part of the community estate, and as such, each spouse is entitled to one-half the couple's quasi-community property.

2. Death. In California, Washington,⁴⁰ Idaho (among others), a surviving spouse is entitled to a forced one-half share of the deceased's spouse's quasi-community property. (A non-moneyed spouse who predeceases is out of luck.)

- a) Spouse's Right to Reimbursement – Quasi-Community Property

- (1) In California, if the deceased spouse has made a gift of his or her quasi-community property without the surviving spouse's consent, the surviving spouse may require the

³⁵ Wash. Rev. Code § 26.16.200 (1997). See *de Elche v. Jacobsen* (1980) 95 Wash. 2d 237 (share of tortfeasor in community property liable for tort recovery with right of reimbursement in nontortfeasor spouse).

³⁶ See, e.g. Cal. Fam. Code, § 125.

³⁷ Cal. Fam. Code, §63.

³⁸ Ariz. Rev. Stat. Ann. § 25-318(A).

³⁹ N.M. Stat. Ann. § 40-3-8(C).

⁴⁰ Wash. Rev. Code § 26.16.220

third-party transferee to return one-half of the value of the property to the decedent's estate.

(2) Washington and has a similar law permitting a surviving spouse to claim quasi-community property transferred by the deceased spouse to a third party within three years prior to the deceased spouse's death.⁴¹

J. Transmutation

Transmutation refers to the interspousal transfer of title to property, from a spouse's separate property to community property or the other spouse's separate property, or from community property title to the separate property of a spouse.⁴² Transmutation involves the intentional transfer of beneficial interest in that property.

1. Formalities:

a) California

(1) A transmutation of real or personal property is not valid unless made in writing and consented to or accepted by the spouse whose interest in the property is adversely affected.⁴³

(2) While a statement in a Will of the character of property is *not* admissible in a divorce proceeding,⁴⁴ a statement in a revocable trust regarding the character of property is admissible.

b) Texas

While Texas has always permitted partitions of community property into separate property,⁴⁵ prior to January 1, 2000, it was *unconstitutional* for a married couple to convert separate property to community property by agreement.

⁴¹ Wash. Rev. Code § 26.16.240. Idaho has a similar statute.

⁴² Cal. Fam. Code, § 850.

⁴³ Cal. Fam. Code, § 852(a). The writing requirement does not apply to gifts between spouses of "clothing, wearing apparel, jewelry, or other tangible articles of a personal nature that is used solely or principally by the spouse to whom the gift is made and that is not substantial in value taking into account the circumstances of the marriage." Cal. Fam. Code, § 852(c).

⁴⁴ Cal. Fam. Code, § 853(a)

⁴⁵ Tex. Fam. Code, § 4.102. Texas spouses may also agree that income from such separate property will be separate property. Tex. Fam. Code, § 4.103.

Texas Family Code sections 4.202 et seq. now set forth the requirements for an effective transmutation from separate property to community property.

(1) The agreement must be in writing and: a) signed by the spouses; b) identify the property being converted, and c) specify that the property is being converted into the spouses' community property.⁴⁶

(2) The agreement does not mean that the newly created community asset is subject to joint management, which still depends on record title or possession.⁴⁷

(3) The agreement is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not: a) execute the agreement voluntarily, and b) receive a fair and reasonable disclosure of the legal effect of converting the property into community property.

(4) An agreement is presumed to provide a fair and reasonable disclosure of the legal effect of the transmutation if it contains a statement, prominently displayed in bold-face type, capital letters, or underlined, as set forth in the statute, describing the agreement's effect on a) exposure to creditors, b) loss of management rights, and c) loss of property ownership.⁴⁸ This language is included in Exhibit B, an example of a separate-to-community transmutation agreement.

2. Issues With Transmutation

a) Right of Reimbursement. If a transmutation is not carried out with the formalities required by the statute, the spouse making a gift of separate property to the community may be entitled to reimbursement.⁴⁹

b) Creditors. Transmutations are subject to the laws governing fraudulent transfers.⁵⁰

c) Undue Influence. Similar to the laws of Texas, above, in California, when an interspousal transaction benefits one spouse,

⁴⁶ Tex. Fam. Code, § 4.203.

⁴⁷ Tex. Fam. Code, § 4.204.

⁴⁸ Tex. Fam. Code, § 4.205(b).

⁴⁹ See, e.g., Cal. Fam. Code, § 2640.

⁵⁰ Cal. Fam. Code, § 851; Tex. Fam. Code, § 4.106.

the law *presumes* the transaction has been induced by undue influence. Once the presumption arises, the burden of proof is on the advantaged party to show that there was no undue influence. In that connection, the presumption in Evidence Code section 662 that title to property reflects the ownership of that property is trumped by the Family Code section 721 presumption of undue influence. The advantaged spouse must establish the following elements to prove no undue influence: (i) that the transmutation was freely and voluntarily made by the disadvantaged spouse; (ii) with full knowledge of all the facts; and (iii) with a complete understanding of the effect of the transfer.⁵¹

K. Retirement Benefits

1. Generally. Retirement benefits are usually part separate property and part community property, in proportion to the plan contributions before and during marriage.
2. ERISA Preemption. ERISA will preempt state community property law to the extent that state law grants a non-participant spouse testamentary disposition rights over an ERISA-covered employee benefit plan that are inconsistent with ERISA.⁵²
3. Punt. A full discussion of the innumerable nuances in the community property retirement plan benefits arena is beyond the scope of this presentation.

L. Management

Managerial rights vary between the states.

1. General Rule: Equal rights to manage.
 - a) Each spouse has equal rights to manage the community without the joinder of the spouse
 - b) Exceptions:
 - (1) Gifts. In some states, a gift of community property without the spouse's consent can be set aside during the donor spouse's lifetime or (to the extent of 1/2 of the

⁵¹ *In re Marriage of Delaney* (2003) 111 Cal.App.4th 991.

⁵² *Boggs v. Boggs*, 117 S.Ct. 1754 (1997).

property) on the donor's death.⁵³ Some states apply a *de minimus* exception for small gifts.⁵⁴

(2) Transfers/Encumbrance of real property. Likewise, in all states, a spouse cannot transfer or encumber community real property without the joinder of the other spouse.⁵⁵

2. Texas Twist:

a) "Joint Community Property." Under Tex. Fam. Code section 3.102(b), community property is subject to each spouse's joint management, control and disposition.

b) "Special Community Property." Under Tex. Fam. Code section 3.102(a), each spouse has sole management, control and disposition of the community property that he or she would own, if single, including personal earnings, revenue from separate property and increases and revenues from his or her "special community property"

3. Relevance

Managerial rights may not be relevant to a lawyer in a common law jurisdiction dealing with imported community property. Once the nature of the spouses' ownership interests are recognized under community property principles, the common law jurisdiction will apply its own rules and policies in determining creditor rights and the spouses' lifetime powers to manage the property.

II. Crossing State Lines

A. Community Property is Portable

Generally, when a husband and wife move from a community property state to a common law state, their community property (including property acquired with community funds and property traceable to those funds) continues to be community property.⁵⁶ Few common law states have actually addressed the issue, however.

⁵³ See, e.g., Cal. Fam. Code, § 1100(b).

⁵⁴ Arizona, New Mexico, Louisiana and Wisconsin permit "reasonable gifts" with the spouse's consent. Texas permits the managerial spouse to dispose of his or her sole management community property without the consent of the other spouse so long as the disposition does not constitute a "fraud" on the community property interests of the other spouse.

⁵⁵ See, e.g., Cal. Fam. Code, § 1102(a).

⁵⁶ *Restatement (Second) of Conflicts of Laws* §§ 259 and 260 (1971); *Rozan v. Rozan* (1957) 49 Cal. 2d 322.

B. Personal Property

The law of domicile at the time of acquisition of the property usually determines the nature of spouses' rights in tangible and intangible personal property.⁵⁷

C. Real Property

The law of the situs state controls the ownership interests of each spouse in real property and the income from it, including the community property interest. The situs state may choose to apply the state of the couple's domicile.⁵⁸

D. Uniform Disposition of Community Property Rights at Death Act (The Act).

1. The Act has been enacted in 14 states.⁵⁹ These states recognize and preserve community property brought from a community property state for purposes of disposition at death. The Act applies to:
 - a) Personal property, wherever located, that was acquired as, or became, and remained community property under the laws of another jurisdiction, or that was acquired with income or proceeds from community property, or is traceable to community property.
 - b) Real property purchased *in the Act state* with community property brought into the Act state.
2. The adoption of the Act by a state may be an indication that the state will apply the law of domicile at the time of acquisition with respect to creditor rights, managerial rights, and division upon divorce.
3. Note that the Act creates only a rebuttable presumption. Property, title to which is taken by the husband and wife with a right of survivorship while domiciled in the common law state, will be separate.

III. Planning With Community and Separate Property

A. Benefits of Community Property

1. IRC § 1014(b)(6) Step Up in Basis of Entire Property at the Death of the First Spouse⁶⁰

⁵⁷ *Restatement (Second) of Conflicts of Laws*, §§ 258, 259 (1971).

⁵⁸ *Restatement (Second) of Conflicts of Laws*, § 234 (1971).

⁵⁹ Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Virginia and Wyoming.

2. Full Funding of Applicable Exclusion Amount
3. Minority Interest Discounts for Closely Held Businesses
4. Fractional Interest Discounts for QTIP Trusts
5. Fractional Interest Discounts for Real Estate
6. Permits a Spouse to Effectively Gift-Split without Requiring that All Gifts Be Split in That Year

B. Preserving Community Property When Moving to a Common Law State

1. The spouses can enter into an agreement preserving community property (see the example at Exhibit A) or create a joint community property revocable trust.
2. Segregate community property assets in a separate account
3. Do *not* re-title community property assets in joint tenancy

C. Creating Community Property After Moving to a Community Property State

As discussed above, the assets of clients moving from a common law state to a community property state may consist in large part of quasi-community property. Quasi-community property is *NOT* community property. Therefore, in order to avail themselves of the many benefits of community property ownership, married couples moving to a community property state should consider transmuting their respective quasi-community property to community property (subject to the caveats listed below in E.) by written agreement.

D. Exhibits: Creating Community Property in a Community Property State

Attached as Exhibits B and C are agreements transmuting separate property from each spouse to community property. Exhibit B contains language mandated by Texas law, and Exhibit C, based on California law, incorporates provisions protecting the attorney who represents both parties to the transaction.

E. CAUTION: Slipping Up With Community Property

1. Community property should not be used to fund a Grantor Retained Annuity Trust (GRAT), a Qualified Personal Residence Trust (QPRT), or an insurance trust.

⁶⁰ Note that the deceased spouse must survive for one year in order for property transferred to that spouse from the surviving spouse to receive the joint step-up in basis. IRC § 1014(e).

- a) GRATs and QPRTs. Funding with community property only increases the chances that the GRAT or QPRT will fail due to the death of a grantor. Splitting the community into separate property avails the donors of a discount upon funding. Also, if one spouse dies, only 50% of the property will be included in the deceased spouse's estate.
- b) Insurance trust. If a life insurance trust is funded with community property or the separate property of the uninsured spouse, if the trust is intended first for the surviving spouse and then for the children, the portion of the trust deemed created by the uninsured spouse will be taxed on his or her death.⁶¹
- c) In these cases, clients should fund the respective trusts solely with separate property - by using existing separate property, or by transmuting community property to separate property. Attached as Exhibit D is an example of an agreement transmuting community property to separate property.

2. Potential Horrors of Transmuting Separate Property to Community Property

- a) Step Down in Basis. Remember that community property receives a full step-up or *DOWN* at the death of the first spouse. If assets have depreciated in value, consider transferring them to the healthy spouse as separate property.
- b) Exposure to Creditors. Transmuting separate property to community exposes the assets to the other spouse's creditors.
- c) Divorce. Imagine the unhappy client who transmutes his/her separate property to community property for estate planning purposes when his/her spouse runs off with the pool boy/Hooters waitress.
- d) Non-Citizen Spouses. Transmuting from quasi-community or separate property to community will constitute a gift that may exceed the annual non-citizen spouse gift tax exclusion amount.⁶²

F. Dividing Community Property Into Separate Property, or Preserving Separate Property

⁶¹ IRC § 2036.

⁶² IRC § 2523(i)(2).

1. Estate Planning. As outlined above, certain estate planning vehicles should be funded only with separate property.
2. Creditors. If one spouse is engaged in an ultra-hazardous activity or profession (say, a pilot performing at aerial shows in World War I vintage planes, or an anesthesiologist), consider transmuting a portion of the community to separate property of the non-risky spouse. Of course, this transfer would be subject to fraudulent transfer laws.
3. Spouses. Especially in second (or third) marriages, absent a pre-marital agreement, the spouse with substantial property should preserve his or her separate property to diffuse disputes with children from the first marriage and to protect the moneyed spouse from the predatory spouse.

IV. Examples – Following Pages

The examples are agreements gathered over the years, modified for this presentation, and are provided for illustrative purposes only. No warranties or representations are made as their effectiveness; we will comment on the relative merits of the agreements in our presentation.

AGREEMENT
PRESERVING COMMUNITY PROPERTY STATUS
OF PERSONAL PROPERTY

This Agreement, dated _____, 2005, is entered into between JOHN J. DOE and JANE N. DOE, Husband and Wife, residents of the city of New Canaan, county of Fairfield, state of Connecticut.

RECITALS:

1. Husband and Wife were married on March 11, 1981, and were residents of Connecticut from the time of their marriage until September 1992, when they moved to California. Husband and Wife resided in California while married from September 1992 until October 2003.

2. While residing in California, Husband and Wife transferred personal property that they had acquired with the earnings of Husband and Wife while living in Connecticut into their joint names as community property, with the intention of transmuting the property to community property.

3. While residing in California, Husband and Wife acquired personal property with the earnings of both of them, which property was taken and held in their joint names as community property.

4. The property described in Exhibit A hereto (the "Property") is comprised exclusively of personal property described in paragraphs 2 and 3 above; namely, the community property of Husband and Wife.

5. Husband and Wife wish to confirm the community property nature of the Property and their intent that the Property retain the legal characteristics of community property under the laws of the state of California, notwithstanding their current domicile in Connecticut and any future domicile.

AGREEMENT

THEREFORE, Husband and Wife agree as follows:

A. All personal property listed on Exhibit A hereto (“the Property”) is hereby acknowledged as and shall remain community property under the law of the State of California to the fullest extent permissible under the law of the domicile of Husband and Wife at the relevant time, including, without limitation, the law of the state of California as it pertains to creditor rights, property management, management duties owed to each other and the community, disposition upon divorce, and disposition upon death of community property. Without limiting the generality of the foregoing, all appreciation of and income from the Property shall be community property, regardless of the respective efforts contributed by either spouse that may contribute to such income and appreciation. Husband and Wife realize that changes in California law or changes in domicile could, in the absence of this Agreement, affect their property rights. Husband and Wife intend this Agreement to finally determine their property rights in the Property and as to each other and do not intend that future changes in the law or domicile will affect such rights.

B. Husband transmutes into the community property of Husband and Wife any separate property interest he may have in the Property, and waives any right of reimbursement for any such interest.

C. Wife transmutes into the community property of Husband and Wife any separate property interest she may have in the Property, and waives any right of reimbursement for any such interest.

D. All property whether real or personal acquired by Husband and Wife jointly with the Property or proceeds of the Property shall be deemed to be held as their community property under Paragraph A of this Agreement unless Husband and Wife specifically agree otherwise in a written document signed by each of them specifically referring to and modifying this Agreement.

E. This Agreement shall not alter the rights of Husband and Wife, jointly or individually, with respect to any real or personal property now owned, or owned in the future, in joint name or in the individual name of Husband or Wife that is not the Property or derived from the Property as provided above.

F. Any division of community property between Husband and Wife shall be made on the basis of a non pro-rata division of the aggregate value of the community property (the “aggregate” theory), rather than on a division of each individual item of community property (the “item” theory).

G. This Agreement shall be controlled, construed and enforced in accordance with the law of the State of California.

H. This Agreement shall be binding upon and shall inure to the benefit of the heirs, successors and legal representatives of Husband and Wife.

I. Husband and Wife shall execute any further instruments and documents and diligently undertake such actions as may be required in order to consummate this

Agreement and all further agreements herein contemplated and to use their best efforts to accomplish such agreements in accordance with the provisions hereof.

J. This Agreement constitutes the entire understanding between the parties concerning the subject matter it covers, and supersedes any prior agreements, negotiations and communications, oral or written.

K. Husband and Wife have consented to joint representation by [*law firm*] for purposes of drafting and reviewing the contents of this Agreement. In view of the possibility of conflicting legal and property interests between the parties, each party has been encouraged to obtain independent counsel to advise him or her concerning this Agreement, and each party knowingly and voluntarily waives the right to do so.

L. This Agreement may be modified only by a writing specifically referring to this Agreement signed by Husband and Wife.

IN WITNESS WHEREOF, Husband and Wife have signed this Agreement on the day and year first above written.

JOHN J. DOE
Husband

JANE N. DOE
Wife

AGREEMENT BETWEEN SPOUSES REGARDING THE
CONVERSION OF SEPARATE PROPERTY INTO COMMUNITY PROPERTY

This Agreement (the "Agreement") is made as of _____, _____ between _____, ("Husband") and _____ ("Wife"), both residents of _____ (collectively referred to at times in this Agreement as "the Parties" and individually referred to at times in this Agreement as "the Party").

1. Husband holds, as Husband's separate property, interests and incidents of ownership in certain personal property as described on Schedule A (the "Property").

2. [Texas: Husband and Wife desire by this Agreement and pursuant to Sections 4.202 and 4.203 of the Texas Family Code, to convert the Property into the community property of Husband and Wife.] [California: Husband and Wife desire by this Agreement, in accordance with California Family Code Section 852, to transmute the Property into the community property of Husband and Wife.]

3. The Parties acknowledge that this Agreement does the following with respect the Property:

a. This Agreement changes Husband's separate property to the community property of Husband and Wife.

b. As a result of such change in ownership, this may have adverse consequences during the Parties' marriage and on termination of the Parties' marriage by death or divorce including, but not limited to, the following:

i. Exposure to Creditors. If Husband signs this Agreement, all or a part of the Property which is to be converted to community property of Husband and Wife may become subject to the liabilities of Wife. If Husband does not sign this Agreement, the Property is generally not subject to the liabilities of Wife unless Husband is personally liable under another rule of law.

ii. Loss of Management Rights. If Husband signs this Agreement, all or a part of the Property which is to be converted to community property of Husband and Wife may become subject to either the joint management, control, and disposition of Husband and Wife or the sole management, control, and disposition of Wife alone. In that event, Husband will lose Husband's management rights over the Property. If Husband does not sign this Agreement, Husband will generally retain those rights.

iii. Loss of Property Ownership. If Husband signs this Agreement and the Parties' marriage is subsequently terminated by the death of either Party or by divorce, all or part of the Property which is to be converted to community of

Husband and Wife may become the sole property of Wife or Wife's heirs. If Husband does not sign this Agreement, Husband generally cannot be deprived of ownership of Husband's separate property on termination of the marriage of the Parties, whether by death or divorce. [CA: Accordingly, and without limiting the generality of the foregoing, Husband waives his right to reimbursement under California Family Code Section 2640.]

4. Husband intends to convert the Property into the community of the Parties, without prejudice to Husband's preexisting creditors.
5. This Agreement shall be binding on and shall inure to the benefit of the respective legatees, devisees, heirs, executors, administrators, assigns and successors in interest of the Parties.
6. The Parties will execute additional instruments necessary to carry out this Agreement.
7. The Parties hereby specifically and expressly acknowledge and declare that they:
 - a. have been informed as to the facts relating to the subject matter of this Agreement and as to the rights and liabilities of both Parties;
 - b. have given careful and mature thought to the making of this Agreement;
 - c. have carefully read each provision of this Agreement;
 - d. do understand each provision of this Agreement both as to the subject matter and legal effect;
 - e. are each executing this Agreement voluntarily; and
 - f. waive any disclosure of property or financial obligations of the other Party, except for the information set forth in this Agreement.
8. This Agreement shall be enforceable without consideration made by or on behalf of either Party.

SIGNED this _____ day of _____, at _____.

Husband

Wife

TRANSMUTATION AGREEMENT
[Separate Property to Community Property – California]

THIS AGREEMENT is made this _____ day of _____, 2008, by and between _____ (“Husband”) and _____ (“Wife”), husband and wife, upon the following premises:

WHEREAS,

A. Husband holds title to certain property in his own name or as Trustee under Trust Agreement dated _____, 2008, between Husband and Wife as Trustors and as Trustees, [under Declaration of Trust dated _____, 2008] as his sole and separate property, which property is more particularly described in Schedule A attached hereto and made a part hereof by this reference.

B. Wife holds title to certain property in her own name or as Trustee under Trust Agreement dated September 21, 1995, between Husband and Wife as Trustors and as Trustees, [under Declaration of Trust dated _____, 2008] as her sole and separate property, which property is more particularly described in Schedule B attached hereto and made a part hereof by this reference.

C. Husband and Wife desire to transmute their respective separate property from their separate property assets and liabilities to the community property assets and liabilities of the parties.

D. [Husband and Wife hold title to certain property in their own names or as Trustees under Trust Agreement dated _____, 2008, between Husband and Wife as Trustors and as Trustees, as their community property, which property is more particularly described in Schedule __ attached hereto and made a part hereof by this reference.

E. Husband and Wife desire to transmute their community property assets and liabilities to the respective separate property assets and liabilities of each of the parties.] Husband and Wife intend that the provisions of this Agreement fully comply with the requirements of section 852 of the California Family Code for the transmutation of property of married persons. Husband and Wife further intend that the provisions of this Agreement shall be valid and enforceable and if any provision of this Agreement be determined to be invalid or ineffective for any reason, all other provisions of this Agreement shall nevertheless continue to be fully enforceable.

F. Husband and Wife intend that the provisions of this Agreement shall be effective in determining each party’s rights to the assets and the liabilities listed in Schedule __ attached hereto, including any rights in the event of a divorce, the dissolution of their marriage or in the event of a legal separation, whether their property

rights are ultimately governed by the laws of California or any other jurisdiction in which they may reside.

G. This Agreement is expressly intended to be a waiver by Husband and Wife of their rights to reimbursement within the meaning of California Family Code Section 2640.

NOW THEREFORE, in consideration of the premises and of the mutual agreements herein contained, Husband and Wife agree as follows:

1. The assets and liabilities described in Schedule A attached hereto are hereby transmuted from the separate property assets and liabilities of Husband to the community property and community liability of the parties, and the respective interest of each of the parties hereto in such community property is subject to the testamentary disposition by Will or descent of each of the parties. Husband and Wife understand that by this Agreement Husband is making a gift of one-half ($\frac{1}{2}$) of the separate property now owned by them, subject to one-half ($\frac{1}{2}$) of any liabilities thereon, to the other. Wife understands that by this Agreement she is accepting one-half ($\frac{1}{2}$) of the separate property gifted to her by Husband and is assuming one-half ($\frac{1}{2}$) of any liabilities thereon.

2. The assets and liabilities described in Schedule B attached hereto are hereby transmuted from the separate property assets and liabilities of Wife to the community property and community liability of the parties, and the respective interest of each of the parties hereto in such community property is subject to the testamentary disposition by Will or descent of each of the parties. Husband and Wife understand that by this Agreement Wife is making a gift of one-half ($\frac{1}{2}$) of the separate property now owned by her, subject to one-half ($\frac{1}{2}$) of any liabilities thereon, to the Husband. Husband understands that by this Agreement he is accepting one-half ($\frac{1}{2}$) of the separate property gifted to him by Wife and is assuming one-half ($\frac{1}{2}$) of any liabilities thereon.

3. The assets and liabilities described in Schedule ___ attached hereto are hereby transmuted from the community property assets and liabilities of Husband and Wife to the separate property and liability of Husband/Wife, and the separate property interest of Husband/Wife in such separate property is subject to the testamentary disposition by Will or descent of Husband/Wife. Husband and Wife understand that by this Agreement Husband/Wife is making a gift of one-half ($\frac{1}{2}$) of the community property now owned by him/her, subject to one-half ($\frac{1}{2}$) of any liabilities thereon, to Husband/Wife. Husband/Wife understands that by this Agreement he/she is accepting one-half ($\frac{1}{2}$) of the separate property gifted to him/her by Husband/Wife and is assuming one-half ($\frac{1}{2}$) of any liabilities thereon.

4. All matters relating to the validity, construction and interpretation of this Agreement shall be determined pursuant to California law.

5. Husband and Wife have each had an opportunity to be represented in negotiations for and in the preparation of this Agreement by counsel of his or her own

choosing. Husband and Wife desire to be jointly represented by and the law firm of Johnson & Smith LLP and acknowledge that John Johnson has explained to them the legal concepts involved in the transmutation of their separate property assets and separate liabilities thereon into the community property assets and liabilities of the parties [of their community property assets and separate liabilities thereon into the separate property assets and liabilities of Husband/Wife], and their right to independent counsel in order to safeguard their individual interests, but nevertheless, the parties desire to proceed with this Agreement. Husband and Wife have each read this Agreement and is fully aware of the contents hereof and of its legal effect.

6. Husband and Wife each understand that they have potentially adverse and conflicting interests, but each believes that those interests can be settled amicably with the assistance of John Johnson and have requested that John Johnson represent the interests of both parties in connection with this Agreement.

7. Each of the parties understands that Rule 1.7 of the American Bar Association's Model Rules of Professional Conduct provides as follows:

Rule 1.7. CONFLICT OF INTEREST: GENERAL RULE.

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

- (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
- (2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected; and
- (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

8. Each of the parties understands that California State Bar Rule of Professional Conduct 3-310 states the following:

Rule 3-310. Avoiding the Representation of Adverse Interests.

* * * *

(B) A member shall not accept or continue representation of a client without providing written disclosure to the client where:

* * * *

(4) The member has or had a legal, business, financial, or professional interest in the subject matter of the representation.

* * * *

(C) A member shall not, without the informed written consent of each client:

* * * *

(2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict.

9. This Agreement shall bind the parties hereto and their respective heirs, executors and administrators.

10. This Agreement contains the entire understanding and agreement of the parties with respect to the transmutation of Husband's and Wife's separate property and any liabilities thereon into the community property and community liability of the parties, and there have been no promises, representations, agreements, warranties, or undertakings by either party to the other, either oral or written, of any character or nature, except as set forth herein. This Agreement may be altered, amended, modified, superseded or revoked only by an instrument in writing, executed and acknowledged by the parties to the Agreement and by no other means. Each party waives the future right to claim, contend, or assert that this Agreement has been altered, amended, modified, superseded, or revoked by an oral agreement, form of title, course of conduct or estoppel.

11. If any provision of this Agreement be determined to be invalid or ineffective for any reason, all other provisions of this Agreement shall nevertheless continue to be fully enforceable.

IN WITNESS WHEREOF, the parties have executed this Agreement the day and year hereinabove written.

Wife

Husband

TRANSMUTATION AGREEMENT
[Community Property to Separate Property]

This Agreement is made on _____, between Brad (“Husband”) and Angelina (“Wife”), of _____, California, who may be individually referred to herein as a “Spouse” and collectively referred to herein as the “Spouses,” pursuant to California Family Code section 850.

I. RECITALS

1. Husband and Wife own certain shares of the common stock of Acme Co. (the “Stock”) acquired with their community property. Accordingly, each Spouse owns an undivided one-half interest in the Stock. The Spouses seek to transfer and assign the Stock to Roadrunner, LLC in exchange for membership units of Roadrunner, LLC (the “Units”), which Units shall, as a result, initially constitute community property.

2. Husband and Wife seek to transmute their undivided one-half community property interests in the Units into two separate and divided one-half separate property interests of each Husband and Wife.

3. After the transmutation of their undivided one-half community property interests in the Units into two equal separate property interests, Wife shall own 50 Units of Roadrunner LLC, as her sole and separate property, and, Husband shall own 50 Units of Roadrunner LLC, as his sole and separate property.

4. [At this time, Wife seeks to give a part of her separate property Units of Roadrunner LLC to the Jane GRAT, and Husband seeks to give a part of his separate property Units of Roadrunner LLC to the Ted GRAT.]

II. TERMS

FOR VALUABLE CONSIDERATION, receipt of which is hereby acknowledged, the Spouses declare and agree as follows:

1. The Recitals are a part of this Agreement.
2. This Agreement shall finally determine their property rights to the Units.
3. Husband and Wife hereby transmute their undivided one-half community property interests in the Units into divided and equal one-half separate property interest held by each Husband and Wife. Pursuant to such transmutation, (i) Husband hereby owns 50 Units of Roadrunner LLC, as his sole and separate property, and (ii) Wife owns 50 Units of Roadrunner LLC, as her sole and separate property.
4. Wife waives any right to reimbursement for any community property interests of hers in the Units.
5. Husband waives any right to reimbursement for any community property interests of his in the Units.
6. The Spouses acknowledge that such change in ownership may have adverse consequences to one or both of them during their marriage and on termination of their marriage by death or divorce including, but not limited to, the following:
 - a. Loss of Management Rights. Husband and Wife shall lose management rights over the separate property of the other Spouse created hereby; the respective separate property of Husband and Wife created hereby shall be subject to the sole management, control, and disposition of such Spouse.
 - b. Loss of Property Rights. If the Spouses' marriage is terminated by the death of either Spouse or by divorce, the Units converted hereby to

separate property will constitute the sole property of each respective Spouse, and the other Spouse shall have no rights in such property, including, without limitation, the rights of testamentary disposition, and the potential right to inherit a deceased Spouse's entire interest in the Units by intestate succession.

- c. Loss of Joint Step-Up in Basis. At the death of one Spouse, the Units shall receive a step-up in basis only with respect to the separate property of the deceased Spouse; the surviving Spouse's separate property created hereby shall not receive a step-up in basis. If the parties do not sign this agreement, all of the Units will receive a step-up in basis at one Spouse's death.

7. The Spouses intend to convert the Units into the separate property of each Spouse, without prejudice to pre-existing creditors.

8. The Spouses agree to execute any further instruments and documents and undertake diligently such actions as may be required to consummate this Agreement and all further agreements herein contemplated and to use their best efforts to accomplish such agreements in accordance with the provisions hereof.

9. This Agreement shall be governed by and construed in accordance with the laws of the State of California. The Spouses understand that changes in California law or changes of domicile could, in the absence of this Agreement, affect their property rights. The Spouses intend this Agreement to finally determine their property rights in the Stock and as to each other as set forth in this Agreement and do not intend that future changes in the law or domicile will affect such rights.

10. This Agreement supersedes any prior agreements, negotiations and communications, oral or written, and contains the entire agreement between the Spouses as to the subject matter hereof. No subsequent agreement, representation, or promise made by either Spouse shall be of any effect unless it is in writing and executed by the party to be bound thereby.

11. The Spouses have cooperated in the drafting and preparation of this Agreement. Therefore, no construction of this Agreement shall be construed against either Spouse. The Spouses represent and warrant that they are not acting under menace, duress, fraud or undue influence of any kind whatsoever from any person, including the other Spouse, or his or her agent.

12. If any provision of this Agreement is determined by a court of competent jurisdiction to be invalid or unenforceable, the remainder of this Agreement shall nonetheless remain in full force and effect.

The parties have executed this Agreement on the date first above written.

Brad

Angelina