4

Community Property

Learning Objectives

An understanding of the material in this chapter should enable the student to

4-1. Identify the community-property states and the historical origins of the community-property system.

4-2. Describe the nature of community property.

4-3. Explain the general presumption as to marital property.

4-4. Explain the classification rules in community-property states.

4-5. Explain the ramifications of community-property character.

4-6. Explain how transfer taxes are imposed on marital property.

4-7. Explain why changing domicile between common-law and community-property states can pose estate planning problems.

HISTORICAL ORIGINS

The community-property system currently in use in nine states is based on Spanish and French civil law pertaining to marital property rights. Brought to America by Spanish and French colonists, the ancient concept was grounded in a precept of equality. Because a marriage is a community consisting of two marital partners who, through their joint labors, industry, and efforts, contribute to the prosperity of the marriage, both spouses possess an equal right to the property and its benefits.

The planner must be aware that, while the community-property states share some common features and definitions, there is no one uniform community-property system. Although the fundamental aspects of community-property law are similar in the different states, many differences have evolved because of refinements by state legislatures. The estate planner should guard against the expectation that specific aspects of one community-property state carry over to another community-system state.

Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington are the traditional eight community-property states. Wisconsin is recognized as the ninth community-property state since its version of the Uniform Marital Property Act (UMPA), incorporating many community-property concepts, became effective in January 1986. Instead

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of the term *community property,* Wisconsin and Texas use the term *marital property*. While Louisiana still closely follows the civil law, the other states have adopted some traditional American common-law principles to meet changes in societal and economic needs. In addition to the above-mentioned nine community-property states, Alaska allows a statutory election for certain property to be treated as community property. In other words, Alaska has statutory provisions allowing Alaskan residents to elect community property status to the extent provided in a community property agreement or a community property trust. In 1998, Alaska passed a statute permitting nonresidents of Alaska to transfer property into a trust, referred to as a community-property trust. If the trust has one or more Alaskan trustees, any portion or all of the trust property is treated for tax purposes as community property. Generally, these trusts are created so that some or all of the trust property receives a step-up in basis (discussed in a later chapter) at the death of the first spouse.

NATURE OF COMMUNITY PROPERTY

community property

separate property

In community-property states, property interests acquired during marriage are presumed to be owned equally by spouses. The community-property principle recognizes the existence of community ownership of property by husband and wife. In essence each spouse is deemed to own a one-half interest in property acquired during the marriage regardless of which spouse actually acquired, earned, gained, or is otherwise responsible for ownership of the property. This is not to say that all property belonging to a married couple is necessarily community property. A husband and wife can own property separately in their own individual rights. For instance, property owned by either spouse prior to the marriage continues to be the spouse's separately owned property during the marriage (unless affirmative steps are taken by the owner spouse to change the ownership status of the separate property). Property inherited by or gifted to an individual spouse during marriage also retains separate property characterization. Wisconsin uses the terminology of

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the UMPA and refers to separate property as individual property.[11] For purposes of this chapter, the general terms *community property* and *separate property* are used.

PRESUMPTIONS AS TO MARITAL PROPERTY

Generally speaking, the underlying community-property presumption is that property owned by a husband and a wife belongs to both of them in equal shares, except for that property that can be proven to belong to a spouse separately. Concerning certain issues such as termination of a marriage by death or divorce, the rights of creditors, tort liability, and tax treatment, the community-property system generally presumes that all property owned during a marriage is community property. This presumption is not conclusive, however, if the separate status of property can be proven or if there are other relevant facts that rebut the presumption. In other words, the separate property of a spouse must be specifically designated as separate property to retain its noncommunity character. The fact that property is titled in an individual spouse's name or was acquired with one spouse's separate funds may not in itself be sufficient evidence to rebut the community presumption. The facts and circumstances surrounding the use of the property and the conduct of the parties toward the property may be more evidentiary than the title or the source of funds for its initial purchase. Common-law states (that is, non-community-property states) rely directly on deeds and certificates of title to determine ownership.

transmutation

In addition, practically all the community-property states grant spouses the power to determine or change the character of their property as community or separate. For instance, Texas previously only allowed community property to be transmuted to separate property. Recently, however, Texas law permits separate property to be transmuted to community property.[12] Therefore, spouses may change community property to separate property and vice versa. The legal term for voluntarily changing the nature of property is *transmutation* (in Wisconsin, *classification* or *reclassification*). Depending on the type of property and particular circumstances, transmutation may result from contract (bilaterally) or gifts (unilaterally). There are two important transmutation restrictions, however. First, federal law obligations cannot be circumvented by transmuting property; and, second, a transmutation that is effective between spouses may not be effective against third parties like creditors.

The best way to overcome the general presumption favoring community property is for married partners who reside in or move in and out of community-property states to keep complete, organized, and accurate records of their personal financial matters. Another way to secure property ownership is for couples to file an inventory of assets at the time of marriage to serve as an official record of separate identity. Note that in some community-property

11. Wis. Stat. 1985–86, § 766.31.
12. Tex. Fam. Code Secs. 4.201–4.206 (2003).

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states, especially California, the general presumption is less difficult to rebut when the marriage is of relatively short duration. In some states it is possible for individuals to waive their rights in community property in a prenuptial agreement. Although the general community presumption in and of itself is quite straightforward, different circumstances readily lend themselves to more involved issues.

Example

Mary and Anthony became engaged and planned to marry the following spring. They made purchases for their new home and their future together. Although Mary wanted to furnish their home with antiques, Anthony felt that antiques were too expensive and impractical. Before the wedding Mary, the wealthier of the two, decided to purchase the antiques with her own separate funds, and she arranged for delivery to take place after the wedding. In this case, arguments could be made both that the furniture is separate property and that it is community property. Was the furniture acquired before or after the marriage? Although in this scenario the presumption of community property could easily be rebutted, Mary may have intended the property to be community marital property. If the antiques were partially paid for with Mary's separate funds prior to the marriage and the balance paid with community funds after the wedding, are the antiques still Mary's separate property? If the antiques appreciate in value and are later sold at a gain, are the profits community property or separate property?

Separate Property

- property acquired prior to marriage
- property acquired by gift
- property acquired by inheritance, bequest, devise
- property acquired in a court award
- property transmuted into separate property

While earnings from the labor of a husband and a wife are nearly always community property, community-property states are almost evenly divided in how they treat "rents, issues, or profits" of separate property realized during marriage. Idaho, Louisiana, Texas, and Wisconsin generally treat the rents, issues, and profits generated by separate property acquired during a marriage as community property but hold that natural increases in the size or value, that is, appreciation, of separate property due to market changes and inflation continue to be separate property. Therefore, if the separate property

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of community spouses is sold, the gain on the sale continues to be separate property. If the gain is used to acquire other property, the newly acquired property is separate property. In the remaining states, rents, issues, and profits of separate property retain a separate-property identity, but increases in value resulting from community labor and effort belong to the community. In all community-property jurisdictions, however, income and earnings generated by separate property prior to marriage remain separate, and income and earnings produced by community property constitute community property. It is not difficult to imagine the problems that can arise with regard to the benefits flowing from community property. The spouse claiming the separate nature of property has the burden to overcome the community presumption with adequate proof. Evidence of separate ownership is difficult to provide if adequate records are not kept, particularly when there has been commingling of separate and community funds and other assets over the years. Tracing the property's separate identity may be virtually impossible in such cases.

JOINT TENANCY

Property may be held concurrently by two or more individuals with a right of survivorship. The concept of joint tenancy with right of survivorship is embraced by all common-law states. At the time of one spouse's death, the jointly held property passes automatically, by operation of law, to the surviving spouse. Administrative delay is avoided and, because the property does not go through the probate process, probate costs are reduced. The majority of married partners in common-law states own their family residences as joint tenants with right of survivorship or, similarly, as tenants by the entireties.

None of the community-property states recognize the tenancy-by-the-entireties form of ownership, and joint tenancy with right of survivorship is restricted. Some community-property states, however, statutorily create a right of survivorship in the family homestead so that a surviving spouse is not left homeless.

Generally, a survivorship component is not present with community property. This is not to say that married couples in community states cannot hold property as joint tenants with right of survivorship. About half the states permit a survivorship provision with community ownership of property. Four community-property states—Arizona, Idaho, Nevada, and Washington—have laws permitting residents to own property titled as community property with right of survivorship. In these states, this form of titling overrides a community spouse's disposition of the particular property by will. The property, because it passes by operation of law, is not subject to probate. Generally, community property is probate property except in some community states. In these states, if the decedent-spouse's community share passes to the surviving spouse, it does not pass through probate. In other community states, it is strictly an either-or ownership; couples have the choice of owning property in the community sense, jointly with right of survivorship, or as tenants in common.

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Married partners who have acquired property during marriage in a community state and do not want it to be community property have to take affirmative steps to override the community identity with their chosen form of ownership. In most of the community states it is the form of property expressed in the title document that controls. If one of the spouses claims that ownership is other than what is stated in the deed, bank account, certificate, or title, that individual has the burden of proving the alleged form of ownership. For joint ownership to supersede the community presumption, a number of the states require an express reference in the title that the particular property is held as joint tenants with right of survivorship. When community property is titled or retitled in joint tenancy with right of survivorship, a transmutation of the community property into separate property results.

CLASSIFICATION RULES

time of acquisition rule

inception-of-title rule

The general classification rule is known as the *time-of-acquisition rule* or the *inception-of-title rule*. This rule provides that the character of an asset, separate or community, is established at the time the asset is acquired, and once established, the character is not altered by later events. So, if prior to a marriage one of the parties acquires property, it is and remains the acquiring spouse's separate property. If during the marriage the property is improved using community funds, the property is still the acquiring spouse's asset, but the nonacquiring spouse may have a right to reimbursement for one-half of the community funds spent on the improvements.

Example 1 At the time of H and W's marriage, H owned several acres of unimproved land valued at $15,000. Using community funds, H and W built a home for $175,000 and later improved the residence by adding several bedrooms, bathrooms, and an in-ground pool with bathhouse for $50,000. The value of the home is $350,000 at the time H and W divorce. Although the land remains H's separate property, W has a community claim for reimbursement of her half of the community funds expended to improve H's separate property. In the alternative, H has a claim for the value of the land.

Example 2 Using the facts of the previous example, assume the $50,000 of home improvements came from W's separate funds, which W inherited at her uncle's death. W has to affirmatively prove that the $50,000 was her separate property in order to overcome the community presumption.

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A claim to reimbursement, however, may fail when there is evidence of one spouse's intention to make a gift of a community interest to improve the other spouse's separate property.

To establish that property acquired during a marriage is one spouse's separate property, the claiming spouse may show that the asset was acquired in one of the following ways:

- by gift or inheritance
- by purchase with separate property or by separate credit
- by recovery for personal injuries

In keeping with the lack of uniformity among the community-property states, states vary in applying the time-of-acquisition rule. For instance, Louisiana law provides that the character of personal property is established when title passes but that the title for real estate is determined at the time the property is actually conveyed.

PROPERTY CHARACTER

The character of property is determined by the character of the property used to acquire it initially. For instance, if solely separate property is used to acquire other property during marriage, the newly acquired property is also separate property, and when entirely community property is exchanged for other property, the new property retains a community character (absent an agreement of the spouses to treat the property otherwise).

Example John spends his separate funds to make a down payment on a cottage in the mountains to be used as a family vacation home. It is titled in the names of both John and his wife, Jane, since the intention is for the cottage to be community property. It is likely the cottage will be characterized as a community asset, based on the parties' intent.

commingling

Although the rule that property has the same character of the property with which it was acquired seems straightforward, it is not that simple. The characterization of property may become very complex when there has been a commingling of marital property. *Commingling* occurs when properties of different characters are mixed, blended, and jumbled up. In these situations, the community presumption typically prevails over the parties' conflicting claims. Even if the character of the property can be traced, other issues may arise: Do the spouses share the commingled property in percentages proportionate to their separate contributions, or is the commingled property the separate property of one spouse with the other spouse then having the legal right of a

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creditor for reimbursement of contributions made? Furthermore, some states restrict tracing in certain circumstances.

Example Shortly after their marriage, Dave and Betsy open bank accounts in both their names. Each places separate funds in the accounts and over time makes additional deposits using community funds. In the course of the marriage there are withdrawals, purchases, sales, and exchanges of assets with commingled bank funds. If Dave and Betsy should later decide to divorce, they are likely to disagree as to what constitutes community and separate property.

Commingling

Life Insurance

The principles governing the classification of life insurance policies are somewhat different in the community-property states. The treatment of life insurance is an important consideration for estate planners and policy owners because of the impact it may have on a decedent's estate taxes and because it is an asset that is often overlooked by a migrating couple. Fortunately, all of the information needed to classify an insurance policy is written in the policy. To determine and separate policy-ownership interests in community-property states, three basic doctrines are used.

The proration or apportionment doctrine concept is favored in California and Washington to establish policy ownership interests. This method views the separate and community components of policy proceeds proportionately to the separate and community funds applied to the premiums paid. In other words, the proration theory looks to the source of the payment of the policy premiums.[13]

The inception-of-the-title doctrine has been adopted in Texas, Louisiana, and New Mexico in many life insurance cases. This approach looks to the character of the funds used to purchase the policy, whether the purchase occurs before or after the marriage. The original funds used to purchase the policy establish its character. If community funds are used for other premium payments, the surviving spouse has a right to reimbursement for his or her share of community funds used for the payments but does not share in the growth in the policy's value.

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13. *Coffey's Estate*, 81 P.2d 283 (1980).

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The third doctrine classifies life insurance ownership according to the nature of the funds used for the final or last premium payment and has been relied upon in Arizona and Idaho in some group life insurance cases.[14] This approach views all but the final payment as voluntary installment payments and the final premium payment as completing the purchase of the policy. Whole life insurance cases, at least in Arizona, follow a reimbursement theory.[15]

Simply stated, each of the doctrines described above seeks to trace the source of the money applied to the premium payments to determine the character of the policy and the proceeds, and each approach may give rise to some inequities.

Business

If a business is started during the marriage with community property and labor, allocation disputes upon termination of the community are normally easier to resolve than if a premarital business is started with separate property and increases in value after marriage are due at least partially to community capital and labor. An increase in business value during marriage because of improved market conditions does not in and of itself change the original separate character of the business.

Example

Prior to marriage Martha started an interior decorating business. The business owned realty valued at $75,000 at the time of Martha's marriage. At the time of Martha's divorce, which occurred 8 years later, the realty had increased in value to $130,000, due solely to favorable market conditions. The $55,000 increase in value is Martha's separate property.

However, when income is generated by separate property acquired during marriage, approximately half the states consider that the rents, issues, and profits belong to the community, while the remaining states hold that these retain their separate character. Increases in business value attributable to the labor efforts of either or both spouses are frequently held to belong to the community. The issue of labor contributions may be at least somewhat resolved if one or both spouses withdraw a salary from the business. On the whole, the courts appear to be more restrictive in applying commingling concepts to businesses than to bank accounts.

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14. *Gaethje v. Gaethje*, 442, P.2d 870 (1968); *Travelers Insurance Co. v. Johnson*, 544, P.2d (1975).
15. *Everson v. Everson*, 537 P.2d 624 (1975); *Honnas v. Honnas*, 648 P.2d 1045 (1982).

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Debts, Obligations, and Liabilities

Although it may seem logical to assume that community principles apply similarly to assets and liabilities, this is not the case. The states are in much greater accord in the treatment of community assets than of community liabilities. The widest differences among the nine sets of community-property statutes and case law occur in the treatment of liabilities. (The term *liabilities* is typically used in a broad sense to encompass debts, expenses, and obligations.)

There are some areas of relative agreement: (1) a spouse's separate property is usually subject to the claims of the spouse's creditors for the spouse's separate debts; (2) generally, one spouse's separate property cannot be reached by the creditors of the other spouse's separately created debts; and (3) the separate property of both spouses may be available if both partners contracted for the liability.

Differences are more likely to arise when creditors of separately created debt seek to collect from community assets or from one spouse's half of community assets, or regarding the following questions:

- the degree to which community assets are available to satisfy premarital debt
- the order in which assets become available to satisfy liabilities
- the exclusion of specific community assets from the claims of creditors
- the availability of community and/or separate property for liabilities created by one spouse for the benefit of the community
- the use of community property of a later marriage to satisfy alimony and support obligations generated by a spouse's previous marriage and children
- the use of community assets to satisfy one spouse's tort claims

Complexities, problems, and inconsistencies involving community liabilities abound.

COMMUNITY PROPERTY AND TRANSFER TAXES

Federal estate tax law[16] requires a decedent's gross estate to include the value of all property in which the decedent had an interest at the date of death. Property rights, however, are determined under state law. In certain situations this means that federal estate and gift tax provisions are applied to a decedent's property in accordance with state property law provisions. Although it is not explicitly stated in the Internal Revenue Code, case law has traditionally recognized that a decedent-spouse's gross estate includes only the decedent's half interest in community property, even if the community property is titled solely in the decedent's name. On the other hand, in a common-law state, if all the marital property were titled in the decedent-spouse's name alone, the spouse's gross estate would include the value of the entire property. If,

16. IRC Sec. 2033.

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however, spouses in a common-law state hold property titled as joint tenants or as tenants by the entireties, only half the property value is included in the decedent-spouse's gross estate.

Example Harvey and Joan, a married couple, have always lived in a community-property state. At the time of Harvey's recent death, they owned $8,800,000 of community property, all of which was titled solely in Harvey's name. Harvey's adjusted gross estate will include $4,400,000 of community assets. However, if Harvey and Joan lived in a common-law state, the full $8,800,000 would be included in Harvey's adjusted gross estate.

Thus, a decedent-spouse in a community-property state will, in most instances, have a smaller gross estate than the same decedent-spouse in a non-community-property jurisdiction. Of course, after the Economic Recovery Tax Act (ERTA) of 2001 and the unlimited marital gift and estate tax deduction became effective in 1982, the transfer tax discrepancies between community and common-law states became moot.

Example 1 Harvey and Joan have always lived in a community-property state. Harvey dies owning $8,800,000 of community property.

Harvey's adjusted gross estate	$4,400,000
Allowable marital deduction	(4,400,000)
Harvey's taxable estate	0

Example 2 Harvey and Joan have lived all of their lives in a common-law state. Harvey dies owning $8,800,000 of noncommunity property.

Harvey's adjusted gross estate	$8,800,000
Allowable marital deduction	(8,800,000)
Harvey's taxable estate	0

Example 3 Harvey and Joan have lived all of their lives in a community-property state. Harvey dies when there is $8,800,000 of community property. Harvey leaves his community-property share to his son.

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Harvey's adjusted gross estate	$4,400,000
Allowable marital deduction	0
Harvey's taxable estate	$4,400,000

Although the unlimited marital estate and gift tax deduction serves to equalize the transfer tax results between community- and noncommunity-property states when the surviving spouse is the beneficiary of the decedent spouse's estate (as in the preceding examples), if someone other than the surviving spouse receives the decedent's property, transfer tax differences between community and noncommunity jurisdictions are more likely.

testator

widow's election

Sometimes in community-property states a *testator* (a person who has a valid will at his or her death) attempts to devise or control community assets with a will. For instance, a testator may bequeath community property to third parties, or the testator may provide that a trust be funded at his or her death with community assets, giving the surviving spouse an income interest for life and passing the principal to remainderpersons at the survivor's death. To provide relief when a decedent-spouse has taken control of community assets rightfully belonging to the surviving spouse, community-property states have a device called a *widow's election*. This allows the surviving marital partner to choose whether to take half the property outright or to take the benefits provided under the decedent's will. If the surviving spouse decides to abide by the terms of the decedent's will, and under the will the decedent made a testamentary transfer of community assets to a third party other than the surviving spouse, the surviving spouse may be deemed to have made a gift of his or her share of the community property received by the beneficiary under the decedent's will.

CLIENTS ON THE MOVE

Mobility is a common aspect of modern life in the United States. Whether for employment or for personal or other reasons, a significant number of Americans move from one state to another each year. Unfortunately, mobility is often overlooked by planners. Clearly, changing domicile between common-law and community-property states and even between community states can pose some complicated estate planning problems. Often questions are not raised about the legal implications of family moves until there is a death or divorce. Once a marriage dissolves, a determination of the parties' individual legal rights regarding their assets may be formidable or, worse, impossible unless adequate records have been kept over the years.

Moving from a community-property state to a common-law state does not change the character of marital property acquired in the community jurisdiction unless the parties take steps to expressly change the property to a character

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other than its community identity. The Uniform Disposition of Community Property Rights at Death Act has been enacted by more than one-third of the common-law states. This act provides for the recognition of community property as retaining its community-property identity at death when spouses move from a community-property state to a common-law state and when community-property funds are used for the purchase of real property in a common-law state.[17] As is the case with many uniform acts, however, the Uniform Disposition of Community Property Rights at Death Act has not been enacted by the adopting states uniformly. Therefore, the act varies within the adopting jurisdictions. Estate planners of migrant couples also need to be aware of the likelihood that judges and lawyers practicing in one system are probably not familiar with the legal issues of the other system.

Clearly, addressing all the legalities of the community-property systems is beyond the scope of this chapter. However, regardless of the state in which an estate planner practices or a married couple presently resides, a planner should understand that there are two different legal systems affecting marital property. The planner must be aware of the many implications of client mobility and must recognize that wills, trusts, disclaimers, antenuptial agreements, buy-sell plans, and so forth, that are drafted in one jurisdiction have to be reviewed to make sure they are effective in the current jurisdiction.

CHAPTER REVIEW

Key Terms and Concepts

community property
separate property
transmutation
time of acquisition rule
inception-of-title rule
commingling
testator
widow's election

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [4-3] at the end of a question means that the question is based on learning objective 4-3. If there are multiple objectives, they are all listed.

4-1. Identify the community-property states. [4-1]

4-2. Distinguish between separate property and community property in a community-property state. [4-2]

4-3. Describe the best way for overcoming the general presumption favoring community property. [4-3]

17. Unif. Disp. of Comm. Prop. Rts. at Death Act Sec. 2 (1995).

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4-4. Explain the three basic doctrines used to determine and separate life insurance policy ownership interests in community-property states. [4-4]

4-5. What kinds of property are characterized as separate property? [4-3]

4-6. Explain why the transfer tax results between community- and non-community-property states would be similar when the surviving spouse is the beneficiary of the decedent spouse's estate. [4-6]

4-7. Why should the estate planner in a common-law state have a working understanding of community-property laws? [4-5, 4-7]

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