AN OVERVIEW OF COMMUNITY PROPERTY LAW

THE BASIC RULES FOR DETERMINING THE CLASSIFICATION OF PROPERTY

In order to counsel clients on various estate planning matters, the advisor needs to understand the following:

1. How community and separate assets obtain their classification,
2. What legal principles are employed to determine the source of assets,
3. The significance of methods of holding title in determining classification,
4. How agreements between the spouses affect the classification.
5. What legal consequences flow from transactions entered into by the spouses,
6. What presumptions and rules are applied when the sources of assets cannot be traced?
7. What is the impact of moving to or from community property states?

In many cases, courts are applying financial and accounting concepts and theories to determine the classification. Proper record keeping will be invaluable to the client in establishing the true nature and classification of property rights. This includes financial statements and other records prepared with the assistance of the financial advisor.

Advisors are concerned with liabilities as well as assets. The liability of separate and community assets for debts will affect all aspects of estate planning, including the rights of creditors on death or dissolution of the marriage, and rights of creditors in the event of insolvency or bankruptcy.

In the areas of estate planning, decisions may be greatly influenced by community property considerations. For example, the decision as to whether or not to incorporate a closely held business interest may be affected by the management and control rights of the spouses in community and separate property. Consideration must be given to community property rights of a spouse in buy-sell and business continuation agreements. The use of the revocable living trust as a management and estate planning device is heavily influenced by community property considerations. The methods of holding title to property may affect its community or separate status, result in gifts, have an effect on its status in the event of dissolution or death, and affect its income tax basis.

Valuation discounts, which have become an important part of estate planning for family businesses are greatly affected by community property rules. The co-ownership of the business interest by a husband and wife can be the basis for such discounts. See Estate of Bright v. U.S., as discussed in ¶2.15, there are a total of nine states and one territory which follow community property concepts in classifying property acquired by married persons. If you do not live in such a state, need you be concerned? This is an extremely mobile country. If your clients have moved to your state from one of the states which follows community property rules, the chances are very good that money or property they bring with them is community property. The chances are also very good that their ownership rights will be recognized in your state, even if it does not follow the community property system. If so, the advice you give them may affect their property rights to almost the same degree as if you were in a community property jurisdiction.

ii. THE COMMUNITY PROPERTY SYSTEM

HOW DOES THE COMMUNITY PROPERTY SYSTEM WORK?

In order to assist in a basic understanding of the community property system, it is necessary to take a very brief look at its historical background, and how it evolved into the present law. While the community property system of classifying property owned by a husband and wife has been adopted by a minority of jurisdictions in the United States, it can fairly be said it is the predominant form of marital property ownership in a large part of the world. The reason most states do not follow the system is that the British common law, which is the foundation of the U.S. legal system, did not recognize this concept. It has been adopted by nine states The basis of the community property system is the idea that marriage also creates what amounts to an economic partnership between the husband and wife, in which they share ownership of certain property. However, all of these states recognize the spouses may own separate property in which the other has no rights or only limited rights, classified as separate property..

THE STATES WHICH FOLLOW THE COMMUNITY PROPERTY SYSTEM.

The basic format of community evolved from the Roman-Dutch civil law, which eventually came to the U.S. through colonization in the form generally applicable in Spanish-speaking countries. There are eight states that have adopted the community property system based on Spanish-Mexican law, with an overlay of some rules from French law. These are:

Arizona
California
Idaho
Louisiana
Nevada
New Mexico
Texas
Washington

In addition, the state of Wisconsin has adopted in substance the Uniform Marital Property Act, which is based largely on community property principles. Wisconsin can therefore be considered a community property state. While

Wisconsin employs the term “marital property” rather than “community property”, any reference to community property in this treatise will generally apply to Wisconsin marital property. Similarly, “individual” property as that term is used in Wisconsin is roughly equivalent to “separate” property in this discussion. The community property system also applies in the territory of Puerto Rice.

Finally, Alaska has adopted an “elective” community property system for assets transferred to an Alaska trust.

Even though the system adopted in this country came from essentially one source, the Spanish civil law system, it has evolved and been modified in the various community property states in such a way that there are martial differences in community property laws of the various states. In other words community property law is “state specific”. This has made it next to impossible to apply cases and statutes from one community property state While this presentation will discuss the rules applicable in the various community property states, it is not possible in this limited space to discuss all of these differences, and you must be careful to apply the rules as they specifically exist in your particular state, or the state in which the property was acquired.

UNDERLYING PRINCIPLES AND OBJECTIVES

The basic thrust of the community property law is that the acquisition of property by either spouse during marriage through the time, energy, and skill of one or both spouses is treated as a contribution to the community, i.e., the marriage. The result is community or marital property. The contributions may be direct, as one spouse earning a salary, and indirect, as the other spouse taking care of the home. Although the system is in many ways treated as an economic partnership, the relative values of the contributions of each spouse are not an issue, and are presumed equal. Both spouses have protectable property interests in the community property, both during and after marriage. However, the system permits either spouse the ownership of separate property, which is property acquired before marriage, or obtained after marriage through gift, bequest, or inheritance.

While various community property systems have followed a partnership theory of property ownership, the rights of the husband and wife have not always been truly equal. Originally, the husband exercised almost complete control over the community property, and the rights of the wife in the property were clearly not “equal”. For example, even though the wife was treated as a co owner of the property, the law in some states provided that should the wife be the first to die, her share of community property would pass automatically to the surviving husband. As will be discussed subsequently, some vestiges of that rule are still found today.

It is important to determine whether or not the state in which the property was acquired applies community property concepts to both assets and liabilities. In some jurisdictions, such as California, liabilities incurred during the marriage are treated differently then assets acquired during the marriage. In other states, there are "community debts" as well as "community assets."

THE CHARACTERISTICS OF SEPARATE AND COMMUNITY PROPERTY.

The basic premise of community property law is that property acquired during the marriage by either spouse, unless the result of a gift or inheritance, is community property. Subject to several exceptions, everything else is the separate property of the spouse who acquired it. Most if not all community property states assume property acquired during the marriage is community property, and impose the burden of proving it is not on the spouse who claims it is his or her separate property.

Example: George and Martha Washington recently moved to the town in which you practice, which is located in a separate property jurisdiction. In discussing their estate plan, you determine that most of their assets, which are titled in the name of George, were acquired while George and Martha lived in the state of Washington. The clients have retained no specific records on the source of the acquisition of these assets, except:

Both spouses were employed during their marriage while living in Washington.

When they moved to Washington early in their marriage, neither had any property of significant value.

Neither George nor Martha has received any substantial gifts or inheritances during the marriage.

The clients never entered into an agreement before or during marriage pertaining to their property rights.

Based on the foregoing, most community property jurisdictions would apply a presumption that the property is the community property of George and Martha under Washington law.

VARIATIONS IN THE SYSTEM

The actual operation of the system varies among the states. Some states have adopted interpretations that are not necessarily followed in other community property states. For example, because the public policy of California strongly favors community status for assets acquired during marriage, certain separate property acquired by married persons in other states which would have been community property if acquired in California is reclassified from separate property to “quasi-community property ” for certain specific purposes, such as transfers at death or dissolution of the marriage. This concept has been applied in other community property states. Quasi-community property is discussed in greater detail subsequently,

THE REQUIREMENT OF A MARRIAGE

A basic requirement for the application of the Spanish and French community property systems was a valid marriage of the parties. This has carried over to the U.S. jurisdictions, although most states have relaxed some of the formal and ceremonial requirements for a valid marriage. In general, U.S. courts will approve the validity of a marriage where the parties have substantially complied with the legal requirements, and presume such marriages are valid.

Many community property states, including California, Texas, and Louisiana, have developed the concept of a “putative” marriage, which generally means a marriage which is legally invalid, but in which one or both of the participants believes in good faith there is a marriage. Any property acquisitions during a putative marriage are identified as "quasi-marital" property, and are generally subject to the same rights as community property in a valid marriage, at least so far as the innocent spouse who acted in good faith, called the "putative spouse," is concerned. On dissolution, the putative spouse is entitled to equal division of quasi-marital property. If there is none, he or she may recover for the value of services during the putative marriage on a contract theory. The putative spouse is also entitled to a division of the quasi-marital property on the death of the other spouse. This is not expressed in the statute, but is implied from court decisions, which recognized equitable property rights in such situations. For most purposes, a putative spouse would be treated as a surviving spouse on death, and entitled to recover, for example, pension benefits and workers' compensation benefits. Note the state of Washington does not follow this rule.

Example: Charlie, a traveling salesman in California, married Sylvia in San Francisco in 1988. Four years later, he married Prudence in Los Angeles. He maintained residences with each spouse, neither of whom knew of the existence of the other. When he died, Prudence was able to successfully assert a claim against his estate as a surviving spouse. See Estate of Vargas, 111 Cal. Rptr. 779 (1974).

In a very few states, including Idaho and Texas, the law recognizes a “common law” marriage. This is a relationship which has not met the requirements of a valid marriage under state law requirements, but which is still recognized as a marriage. This would not be treated as a putative marriage insofar as property rights are concerned, but as a “real” marriage. Finally, even jurisdictions that do not recognize putative marriages as such are likely to look to partnership law to define the property rights of the spouses. A good example of this is the "Marvin" rule discussed in the following section.

Where both parties to a relationship know they are not married, the putative spouse rules will not apply. In Marvin v. Marvin, 18 C.A.3d 660 (1976), the California Supreme Court expressly held that non marital non putative relationships between persons do not give rise to property rights similar to marital property rights, but that the parties to such a relationship may expressly enter into enforceable agreements relating to property rights arising from the relationship, unless the only "consideration" for such an agreement is sexual services. Further, even if such a contract or agreement was not expressly entered into by the parties, such an agreement could be implied by the conduct of the relationship, or one party could assert property rights against the other party based upon the value of non sexual services performed with the expectation of monetary reward.

Such express or implied agreements might create a form of partnership or joint venture, or in some cases trust principles might be applied to the relationship. Thus the Supreme Court said that the parties to such a relationship may "... agree to pool their earnings and to hold all property acquired during the relationship in accord with the law governing community property... "

AL – WHAT DO YOU THINK THE ODDS ARE THAT EITHER PUTATIVE MARRIAGES OR MARVIN RELATIONSHIPS WILL BE RECOGNIZED IN OTHER STATES?

WHAT IS THE DEFINITION OF "PROPERTY"?

The community property law generally applies to all property acquired by persons who are domiciled in the community or marital property state at the date the property is acquired. The term "property" includes anything that can be classified as a property right, real or personal, legal or equitable, tangible or intangible. Historically, the term property did not include a mere "expectancy," i.e., a possible right that may mature in the future, but not a present property right.

Example: During the marriage of Elmer and Louise, Louise developed a story line for a novel. After the parties divorced, Louise completely rewrote the concept, and it was ultimately published. Did Elmer have any community property interest in the royalties from the novel? See Michel v. Michel, 484 So.2d 829 (La., 1986).

The California Supreme Court, In re Marriage of Brown, 15 C.3d 838 (1976), held that non vested pension rights were not mere expectancies, but contingent community property rights, are. And In re Marriage of Fonstein, 17 C.3d 738 (1976), the same court made the following statement:

"... contractual rights, where the right to payment is earned during marriage, are community property though contingent on future events."

The Brown decision has been followed in other community property states, and has led to litigation involving community property rights in pension plans, deferred compensation agreements, and federal old age benefits, which will be discussed subsequently.

Most of the cases in which the expectancy issue will arise involves employee benefits, particularly pension plans and benefits. These will be further explored subsequently.

MANAGEMENT AND CONTROL

Separate or community property classification also affects the management and control rights of the parties. When it comes to estate planning, it is imperative to know who exercises management in a variety of situations including the making of gifts, transfers of property to revocable trusts, formation of family business entities, family sales of property, etc.
AL – AGAIN, DO YOU THINK THE MANAGEMENT RULES WILL CARRY OVER WHEN SPOUSES MOVE TO SEPARATE PROPERTY STATES? WILL THE SITUS OF THE PROPERTY BE A MATERIAL ISSUE HERE?

In general, each spouse has management and control over his or her separate property. Although there are differences among between the states, the spouses generally have dual control over community property. However, in specified cases, one or the other spouse may exercise control over specific assets. In exercising management over community assets, each spouse owes a duty or good faith and fair dealing to the other spouse, and is sometimes held to the same requirements as a trustee dealing with trust assets.

LIABILITIES AND CREDITORS RIGHTS

The estate planning advisor might assume that there is a concept of community liabilities similar to community assets. That is not the pattern in many community property states, at least where creditors' rights are concerned. Louisiana, and to some extent Washington, compare community assets and liabilities, while most states focus on which assets can be reached by which creditors. In other words, can creditors reach community property, or separate property of either spouse, to satisfy their claims? If so, is there any preference, i.e.; family living expenses are first satisfied from community assets rather than separate assets?

SEPARATE PROPERTY

In order to determine the existence and extent community property owned by a husband and wife, we start with a determination of their separate property. This is based on the prevailing view in the community property states that property acquired or owned by the spouses during the marriage is presumptively community property, and separate property is really the exception to the rule. In other words, the burden is almost always on the spouse who claims any asset is his or her separate property to prove this.

AL – DO YOU THINK THE PRESUMPTION WILL CARRY OVER TO SEPARATE PROPERTY STATES?

Separate property includes property received by gift or inheritance, or acquired before marriage. There are also other categories of separate property. Which vary considerably from state to state. Acquisitions after termination of the community…i.e., property acquired after the parties have divorced or one of them has died, are separate property. In a minority of jurisdictions, including California, this extends to property acquired during separation. "Separation" does not mean mere temporary situations, but mean the parties have come to a definite parting of the ways and have no present intent of resuming their relationship" In some states, particularly California, money or property acquired solely on the basis of the separate credit of one spouse is considered separate property.

Possibly the greatest area of difference in the treatment of property among the community property states relates to the rents, issues, and profits derived from separate property. There is almost an even split among the community property states as to classification of income earned from separate property. Texas, Idaho, Louisiana, and Wisconsin treat the income earned during marriage as community property. This is often referred to as the "civil law" rule. Arizona, California, Nevada, New Mexico, and Washington classify the income from separate property as separate property. This is referred to as the "American" rule.

For purposes of application of one of these two rules, all jurisdictions are classifying income as what the law calls "“rents, issues, and profits"” i.e., rent, interest, dividends, etc., for the recurring investment or use of the property. This will create characterization problems in the five states, which characterize the income from separate property as community. In those states, it is necessary to distinguish "income" from "growth" or "capital appreciation". Generally speaking, the gains derived from sales and conversions of separate property in those 5 states are separate property. This leaves tough questions, such as classification of royalties from assets subject to depletion, and from copyrights or patents, which will be amortized over a period of time.

Some states, including Louisiana and Wisconsin, permit a spouse with separate property to reserve the income from that property as separate property

The issue relating to the classification of income from separate property is further complicated by rules allocating income or even appreciation in separate property of one spouse during the marriage by the labor or management of one or both spouses which contribute to that income or gain, which will be classified as community property. Further, all of the issues of classification of separate and community property assume the funds and assets have not been commingled or confused to the point where classification by allocations not possible.

The issues involved in classification of community and separate property do not end with these definitions. It is necessary to trace the source of property, and that will lead to problems where assets have been commingled. The husband and wife may have entered into an agreement respecting their property, which determines its classification. The new Alaska statute is a good example of this issue. Finally, where tracing the source of property is unsuccessful, there are certain presumptions the states follow in classification.

Property acquired before marriage is the separate property of the acquiring spouse. Where property is acquired before marriage, but paid for, at least in part, during marriage, there are three different theories which apply to determine if it separate or community. The first, called "inception of title", generally holds that where the legal right to the property is acquired before marriage, it is entirely separate property of the acquiring spouse even if paid for in whole or in part during the marriage. States that follow this view, including Texas, generally provide that any consideration paid during marriage from community sources will have to be paid back, i.e., the community property must be reimbursed.

The second theory is a variation of the first, and speaks in terms of when the title to the property vests. For example, assume property is purchased before marriage on an installment contract, all or part of which is paid for during marriage from community sources, and title vests when payment is complete. Since title "vests" during marriage, this is community property, and if one of the spouses used separate funds to help pay for it, the most he or she can receive is reimbursement. Louisiana follows this approach for real property, but inception of title for personal property.

The third theory is a pro-rata allocation in which the property is part separate and part community, depending on the source of payment. This is the California view.

Example: Joan, a single woman, purchased a home in her own name, financing with a promissory note secured by a mortgage on the property. She made the down payment and mortgage payments from her earnings for several months before she married John. John moved into the house, and the remaining payments on the purchase price were made from the earnings of each of them. They are now in the process of a divorce and the community and/or separate property nature of the home is in issue.

In an inception of title state, the house would be the separate property of Joan. John could seek to treat the mortgage payments made from the earnings of both spouses during the marriage as a claim against the property, but would not be entitled to share in the ownership. The same answer would follow in a vesting of title state. However, if the title to the residence did not pass to Joan until the payments of the purchase price were completed, a vesting of title state could conclude the house is community property, and Joan would have a claim for reimbursement of her separate payments on the purchase price. In a pro-rata jurisdiction, the ownership of the house would be apportioned between community and separate property interests based on what part of the price was paid from community funds and what part from separate funds..

Note that all of these theories assume it is possible to “trace” the source of payment for the property in question to separate or community sources. If tracing is not possible, certain presumptions will apply. Also, if there is a commingling of separate and community funds so that it is not possible to directly trace the source of payment, certain other rules and presumptions will apply.

ALLOCATION OF SEPARATE AND COMMUNITY INTERESTS IN PROPERTY BASED ON SERVICES OR LABOR OF A SPOUSE.

The contribution made by one spouse to the acquisition or improvement of property may be in the form of services. This leads to the possible application of the principles of allocation to the community of an interest in separate property of one spouse measured by the value of that spouse's services in managing that property. The rule has most generally been applied to the management of a business interest which is the separate property of the managing spouse. However, it has also been applied to the management of investments which are the separate property of the managing spouse. The basic reasoning behind the apportionment rule in such cases is an implied assumption that the efforts of the spouse in managing the business contributed to its value and profitability, and the community accordingly is compensated. The application of the rule of apportionment here is generally to situations where one spouse brings a separate business or investment into the marriage, and manages it during the marriage. In determining how to allocate the profits and growth of a business or investment to the part produced by the skills of the managing spouse (community) and the part produced by the natural growth of the investment (separate), the courts generally have applied two rules:

1. The "Pereira rule," derived from the decision in Pereira v. Pereira, 103 P 488 (California, 1909), that where the service of the managing spouse during the are the unique, and a major cause of growth during the marriage of a separate business or investment owned by that spouse, the growth is deemed to be community property. However, since the managing spouse did own the business or investment as separate property, he or she is entitled to a reasonable return on that investment, generally measured by a fixed rate of interest.
2. The Van Camp” rule, arising from the court decision in Van Camp v. Van Camp, 199 P. 885 (California, 1921).. In this case, based on a finding that the

growth in the value of the business was primarily caused by economic factors and the separate capital brought into the business, the court held that all the community was entitled to was the reasonable value of the services of the managing spouse during the marriage.

While it may appear these rules are inconsistent, they are not. The difference is that in Periera, the court determined the growth in the value of the business was the skill of the managing spouse. In Van Camp, the court found the growth was due, as indicated, was due to the use of separate capital during the marriage. Several court decisions have pointed out that neither rule is automatic – it will depend on the facts of each case.

Once the court ascertains the extent community interest in the growth or profits of a business under the Pereira or Van Camp rules, it may have to deduct for any family living expenses paid out of the business. which are presumed to come from the community property. Beam v. Bank of America, 490 P2d 257 (California, 1972).

This rule has been applied, with variations, in several community property states, including Arizona, New Mexico, Nevada, and Washington. Texas has wrestled with the concept in various court decisions, in some cases granting the nonmanaging spouse at least a limited right of reimbursement for the value attributed to the management during marriage. Of course, it must be remembered that in Texas, income from separate property is community property, which tends to blunt the impact of this rule, probably only applying it to increases in the value of the business or investment which cannot be classified as income.

AL-MORE ON THIS?

The actual application of the apportionment rule in the case of business and investment profits is complex. Generally, it will be necessary to produce evidence that covers at least the following issues:

1. Assuming the business or investment increased in value during the marriage, to what extent can this be attributed to general economic conditions, the existence of a favorable market, etc.?

2. What was the reasonable value of the services of the managing spouse, and to what extent was the community compensated for those services either by the direct payment of salary or other compensation, or the payment of family living expenses from the business?

A case which is considered by authorities on community property to be a good example of the methodology which should be employed in this area is Cord v. Neuhoff, 573 P2d 1170 (Nevada, 978). In this case, the husband in his will declared that all of the estate was his separate property. His wife claimed it was community property. The couple had first lived in a separate property state, then moved to California, and finally to Nevada. The court determined that the Peirira rule should be used for apportionment, but did it on the basis of a yearly analysis of the income from the property, and a yearly allocation of that income to the separate and community components.

THE REVERSE PEIRERA VAN CAMP ANALYSIS

In those jurisdictons which treat earninings during a peirod of separation as the separate property of the earning spouse, the doctrine discussed above matapply in reverse. .

Example: Doctor Dick has been separated from his wife, Doris, for two years. During that period, he has continued to conduct a very successful medical practice, resulting in substantial earnings and growth in its value. At the date of separation, it is clear the medical practice was community property. However, based on application of rules similar to those followed in Pierera and Van Camp, Doctor Dick is arguing that both the income and growth in the value of the practice during the separation is his separate property.

This doctrine has been adopted in California Marriage of Imperato, 119 Cal Rptr 590 (1975). This implies that the community investment in the business, in this case the practice, is at least entitled to interest on the basis of a Peirera analysis.

COMMUNITY AND QUASI-COMMUNITY PROPERTY.

Either as a matter of statutory law or by adoption of civil law principles, the nine community property states basically define community property as property acquired during marriage that is not separate property under the rules just discussed. The rule will be different in Alaska, where community property can be created only by agreement. Thus community property is defined in terms of what it not separate property. In effect, classification as community property becomes the "default" rule. As a result, there is generally a very strong presumption that if you cannot prove the property or asset in question is separate property, it is community property

In looking at close questions on property classification, a concept, which is traceable to Spanish and civil law, may be helpful. Generally speaking, if the source of the property is a "lucrative"acquisition, it is separate property. This refers through the Latin root to property acquired through gift and inheritable, in other words, not something that is "earned". On the other hand, if the property is based on an "onerous" acquisition, it is property that basically stems from the efforts of one or both spouses during the marriage. Thus the two key questions are:

1. When was the property acquired?
2. How was the property acquired?

FEDERAL PREEMPTION OF STATE PROPERTY LAW

Under the Supremacy provisions in the U.S. Constitution, Congress can legislate special rules pertaining to property rights that override or "preempt" state property law. This includes preemption of community property. For example, as will be discussed in chapter, there are several provisions in the Internal Revenue Code, which indicate that state community property law will be disregarded.

In some cases, as those covered in the Internal Revenue Code, the preemption language is clear. However, most disputes arise where the language in the federal law is not clear. In these cases, federal preemption will be implied through a determination that the rights of the spouses, creditors, beneficiaries and others in the particular item of property are not the same that would follow under state property law.

Example: a member of the armed forces was able to purchase life insurance through payroll deductions, and did so. He was married and his legal residence was in a community property state. Under state law, the insurance policy was clearly community property. See ¶9.14, 915. He named his mother as the beneficiary of the life insurance. When he died, his wife claimed half of the proceeds as community property. The U.S. Supreme Court, in Wissner v. Wissner, 338 U.S. 655 (1950), held that since the insurance plan, sponsored by the federal government, gave the decedent an absolute right to designate a beneficiary, state community property rules had been preempted.

Example: U.S. savings Bonds are purchased with community funds the spouse who purchased them designated a death beneficiary other than the spouse. In two cases, the U.S. Supreme court held the provisions in the beneficiary or ownership provisions of the bonds would be enforced, even though inconsistent with state community property law. Free v Bland, 369 U.S. 663 (1962); Yiatchos v. Yiatchos, 376 U.S. 306 (1964).

Several significant issues and decisions in this area have involved retirement plans either created under federal law, or regulated under federal law, such as the retirement income security act (ERISA). Those and related issues dealing with pensions and IRS are covered subsequently.

THE TERMINABLE INTEREST RULE

The “terminable interest” doctrine generally relates to interests of nonemployee or nonparticipant spouses in retirement plans and death benefits “earned” by the other spouse. Where it is adopted, it carves out a special classification of property which is not treated as owned equally by the spouses.

In states recognizing the terminable interest rule, the answer will generally be that whatever interest the predeceased, nonparticipant spouse has in such benefits will “terminate” on his or her prior death. In addition, it may terminate on divorce.

This doctrine evolved in California, which has since abolished it. Washington specifically does not follow it. Some states follow it in the case of the death of the nonparticipant spouse, but doe treat it as community property at divorce. These include Wisconsin, Texas, and New Mexico. However Texas makes a distinction between private and public pension plans, finding the doctrine is not applicable to private plans.. See Allard v. French, 754 SW2d 111 (Texas, 1988).

All of this is considerably complicated where the plan is a public plan, or is covered by federal preemption.

THE ELECTIVE COMMUNITY PROPERTY SYSTEM IN ALASKA

The Alaska Community Property Act, effective in 1998, allows husbands and wives who are both residents of Alaska to elect the classify property as community. In addition, nonresident spouses may transfer property to an Alaska community property trust, and it will be characterized as community property under Alaska law. In general, Alaska law follows the Uniform Marital Property Act.

Under these circumstances, married couples may elect into community property status for any or all asserts. This may apply to property acquired before marriage, or by gift or inheritance, but only if the election specifically covers such property.

III. MOVING TO AND FROM COMMUNITY PROPERTY STATES

PROPERTY ACQUIRED IN ANOTHER STATE BY THE RESIDENT OF A COMMUNITY PROPERTY STATE

A series of complex legal theories deal with the issue of conflicts of law between and among the various states. These involve concepts such as “domicile”, which is the basis for determining the citizenship and legal residence of a person, or in the case of marriage, of the marriage relationship itself. "Situs" is a legal term that refers to the law pertaining to rights in property located in, or having its "situs" in, a particular state. As a general rule, the situs of real property is the state where it is located, since it cannot be transported from one state to another. In the case of personal property, its situs is generally determined by reference to the domicile of the owner, not the physical location of the property.

Stating the general rules is not necessarily to solve the problems. Many conflicts of law cases arise in the family law area rather than the probate area. In the family law context, many of these problems solve themselves since almost all states subscribe to some sort of equitable division, which creates substantially the same result in common law jurisdictions as in community property states. The theory supporting this is that "separate property" in a community property jurisdiction (which usually cannot be divided) does not mean the same thing as "separate property" in a common law jurisdiction. In the probate area, the results are different in community property states which do not provide for quasi-community property. *See Hanau v. Hanua,* 730 S.W.2d 663 (Tex. 1987) in which the Texas Supreme Court held that the concept of equitable division on divorce did not extend to succession at death, and property acquired by husband in common law state was his separate property for purposes of disposition at death, and wife had no interest therein. Early conflicts law applied the "vested rights" test, which strictly applied the rule that the rights acquired in the domiciliary state were vested and could not be disturbed by the law of a subsequent domiciliary state. The RESTATEMENT (SECOND) OF CONFLICTS OF LAWS. *See* §§6 and 258. The general rule of the Restatement is that the most significant contacts control, but (as noted above) the general rule as to personal property is that the law of the marital domicile at the time of acquisition governs the property. *See*, for example, *Tomaier v. Tomaier*, 23 Cal. 2d 754.

The general rule that the law of the situs governs realty may or not be the case. For example, if California residents acquire real property in a common law jurisdictions, that property should be the community property of the parties. The form in which title is held may present problems in common law jurisdictions.

When these concepts are applied to determine the classification of community and separate property, this will generally be based on the domicile of the husband and wife when it is acquired. This applies to both real and personal property.

Example: Husband and wife, who live in California, purchase stock in a Delaware corporation with their earnings. Even though Delaware is a separate property state, the stock is community property.

Example: A husband and wife living in Delaware purchase real property in California with their earnings. Had they been living in California, it would clearly be classified as community property. However, it will be classified as separate property under the laws of the state of Delaware.

MOVING FROM A COMMUNITY TO A SEPARATE PROPERTY STATE

When a married couple moves from a community property state to a separate property state, all property wherever located that would be deemed to be community property where acquired will still be community property. This will give rise to a series of problems in estate planning..

Example: Husband and wife move from Texas to New York. They have acquired funds that are community property under Texas law, and seek to invest in marketable securities through a New York brokerage firm. The securities they purchase will, unless they agree otherwise, be community property. This is despite the fact that under New York law they may be unable to take title to the securities as community property.

Planning Tip: Where spouses moving from a community to a separate property state are investing community funds, there should be an underlying agreement reciting the fact that the property in question (including real property) is being acquired with community funds, and will retain the status of community property regardless of the title in which held.

Because the proper form of title is a problem in these cases, an attempt may be made to find a title most consistent with the equal ownership found in community property states. For example, this may be as tenants in common. However, assuming the spouses do not intend to change the community status of the property, they should enter into an agreement as suggested above that their intention is that the property retains its status as community property.

Note: For reasons discussed subsequently, is generally not advisable to take title as joint tenants with right of survivorship, at least without the advice of legal counsel.

Some separate property states take a rigid view that the form of title to community property brought into their state must be changed to a common law form, as discussed above. These include Florida, Oklahoma, and Missouri. Colorado. Virginia and Ohio have recognized the existence of the community ownership.

Recognizing the problems created by community property owned by residents in their jurisdictions, several non community property states have adopted the Uniform Disposition of Community Property rights at Death Act which provides that on the death of a spouse, the community property rights of the estate and survivor will be respected.

MOVING FROM A SEPARATE PROPERTY STATE TO A COMMUNITY PROPERTY STATE

Consistent with the rules stated above, when married individuals move from as separate to a community property state, their rights in separate property acquired in the other state should be respected. This may raise issues, beyond the scope of this treatise, as to whether or not the rights they would have had in the former state in such property on divorce or death will carry over.

Example: A husband and wife moved to Idaho from New Jersey. In connection wit their divorce, a dispute arose over the proper award or division of property that was acquired n New Jersey. Assuming it retained its status as separate property, under Idaho law, only the spouse who acquired it, in this case the husband, could claim an interest in it. However, the Idaho Supreme Court applied New Jersey law, which would award an interest in the property to the wife. Berle v. Berle, 546 P2d 407 (1976).

¶465 THE QUASI-COMMUNITY PROPERTY CONCEPT

Concerned with fact patterns like those discussed in ¶455, California adopted legislation which provided that when married persons move to California from a common law jurisdiction bringing assets acquired in the other jurisdiction, even though the assets brought to California were separate property where acquired, they would be community property in California, as would any property acquired in exchange for such assets. This was declared unconstitutional in Estate of Thornton, 1 C.2d 1

The response of the California legislature was to adopt the quasi-community property concept, which generally recognizes the property rights acquired in the other state, but gives the nonacquiring spouse what are essentially community property rights if the acquiring spouse dies, or if the marriage is dissolved. This was held to be constitutional in Addison v. Addison, 62 C.2d 558. Thus California adopted the concept of "quasi-community" property. Unlike the prior law which classified property these statues only deal with certain situations:

1. Rights of a surviving spouse on the death of the spouse who acquired the property.
2. Division of property on dissolution of the marriage.
3. Creditor rights.

For these purposes, "quasi-community" property is defined as property acquired during marriage in a non community property state that would have been classified as community property had the spouse at tat time. There is an exception for transfers at death of real property located in such other states. This is because; as discussed above California cannot directly affect the status of out of state real property.

The theory of quasi-community property is that it will withstand a Constitutional challenge because the legislation avoids directly reclassifying the property as community property. Historically, each state can provides for disposition or division of any property over which it has jurisdiction at death or divorce.

Note that the rights of the spouses in quasi-community property are not equal. Only the spouse who acquires and holds the property has management and control over it. There is apparently no limitation on the acquiring spouse'' right to death with the property. If the non acquiring spouse is the first to die, and property belongs entirely to the spouse who acquired it, and the predeceased spouse has no right to dispose of it by will or otherwise.

Arizona, New Mexico, Texas, and Wisconsin follow laws similar to the California quasi-community property statute in the case of divorce. Wisconsin calls such property "deferred" marital property. Idaho, Washington and Wisconsin also follow the concept at death. Louisiana follows the concept to some extent.

It should be noted that since these laws do not confer equal rights on both spouses, the Internal Revenue Service has refused to recognize quasi-community property as community property for federal tax purposes.

MOVING FROM ONE COMMUNITY PROPERTY STATE TO ANOTHER COMMUNITY PROPERTY STATE

While the law is not entirely clear, some community property states, including California and Louisiana, treat community property brought in from other states as community property under the law of the new state of residence. This can be material, since the community property rights differ dramatically between the states.

AL – WHAT IS THE TEXAS POSITION ON THIS? HOW ABOUT OTHER CP STATES?

SOLUTIONS FOR A MIGRATORY CLIENT

When clients move from a separate to a community property state, or visa versa, good record keeping is extremely important This is to establish what the new clients coming into the new state bring with them, and which assets brought into a state following the quasi-community property rules would have been community property if acquired in the new state. These records should be detailed enough to make it possible to trace such assets and the income therefrom through subsequent transactions. This should of course be done as soon as possible after they arrive in the new state. before they start commingling. See Chapter 7. In some situations, it might be wise to place such assets in a revocable inter vivos trust principally for purposes of segregation.

Because of the difficulties encountered when property in another state is purchased with community funds, a revocable trust might again be used as a management device to preserve community status. If the law of the state of domicile permits, the parties may stipulate that the trust is to be governed by California law, and preserve in it the community. However, legal counsel should check the validity of this arrangement both here and in the other jurisdiction.

THE IMPACT OF LEGAL TITLE
TITLE PRESUMPTIONS

Title to property does not conclusively determine whether it is community, quasi-community, or separate property. The status of property owned by a husband and wife is determined by the time and source of its acquisition. However, legal title to property may create presumptions, Also, some forms of title may not be permitted where the property is community, as the rights of the spouses under that particular form of title are inconsistent with their rights in community property. Obviously, legal title to real and personal property is important not only in determining the interests of spouses, but also to protect the rights of third persons, such as purchasers or creditors, who rely on legal title for their own purposes. Thus it is clear that legal title cannot be easily ignored.

It should also be pointed out that where the form of title creates presumptions, the courts tend to give that presumption greater weight than the general community property presumption. This is presumably because parties other than husbands and wives, such as title insurers, lenders, tenants, and purchasers, also rely on the form of title.

Example: Title to California real property is in the name of Edna, a married woman. However, this title was acquired in 1973, at which time California presumed that property in the name of the wife alone was her separate property. Edna sells the property to Wilbur. Wilbur may conclusively presume that property was the separate property of Edna, even though Edna's husband argues that it was acquired during marriage with community funds.

Another reason the form of title may take precedence over the general community property presumption is that by taking title in a form that is inconsistent with community property ownership, the husband and wife have in effect entered into a "transmutation" agreement changing the character of the property. In this case, the community presumption simply vanishes.

TITLE IN THE NAME OF ONE SPOUSE ONLY

The fact title to property is in the name of one spouse only is generally not determinative of its characterization as separate or community property.

Example: Ronald, exercising his management rights over community property, withdraws funds from a community property banks account and purchases real property, taking title in his name alone. This fact alone should raise no presumption that the property is his separate property.

Thus assuming the source of the acquisition of property can be traced to a separate or community source , sole title in the name of one spouse should raise no presumption as to the status of the property unless the spouses have entered into an agreement which changes or "transmutes" the character of the property. However, there is a rule applicable in some community property states, such as New Mexico and California, which creates a presumption that property in the name of the wife alone is her separate property, which may be a "conclusive" presumption under some circumstances. The genesis of this special rule is found in the days when ,management and control of the community property was vested entirely in the husband.. In that case, the theory was that since the husband "permitted" the title to be vested in the wife alone, he must have intended a transfer of transmutation of his community property rights to her separate property. Local law should be consulted on this issue, since this special rule generally now applies, if at all, only to property acquired before a specific date.

TITLE IN THE JOINT NAMES OF THE SPOUSES

Most of the issues relating to title to property arise when the title is in the name of both spouses. Basically there are four forms of joint ownership which may apply to a husband and wife"

Community property
1. Joint tenancy with right of survivorship
2. Tenancy in common
3. Tenancy by the entirety
4. Tenancy in partnership

Note that a community property form of title is generally recognized in community property jurisdictions, but will not be permitted in common law jurisdictions. This creates great difficult for spouses who want to use community funds to purchase property in common law states. It also causes great difficult with transfer agents and financial institutions which tend to reject the use of the community property form of ownership, even for property such as securities which is treated as haivng a legal situs in the communityproperty state.

The tenancy by the entirely is a form of joint ownership only between a husband and wife which provides a right of survivorship similar to joint tenancy. It should not apply in a community property jurisdiction. Similarly, a tenancy in partnership is unique, and is not necessarily inconsistent with community property.

Example: George and Wilma, husband and wife, decide to invest in a real estate limited partnership. George is designated as the partner, but the interest is purchased with community funds. The partnership interest should, barring an agreement to the contrary, be classified as community property.

TENANCY IN COMMON

Of the remaining forms of coownerwship of property, the tenancy in common between a husband and wife most closely resembles community property, at least where the tenancies are equal.. (It is possible for tenants in common to have unequal interests in the same property). However, there are differences in the rights of tenants in common and the rights of spouses in community property. In general, a tenant in common can sell or give away his or her half interest in the property. This often requires approval of the other spouse in the case of community property. Further, a tenant in common has a legal right under many circumstances to "partition" the property, i.e., physically divide the property into two separate shares, or in the case of real property, parcels. Spouses generally have no such rights in community property.

In Dunn v. Mullan, 296 P 604, (California, 1931), the California Supreme court held that a tenancy in common between a husband and wife resulted in one-half of the property being treated as the separate property of the wife, and the other one-half as community property! The court reached this amazing result based on the rule then applicable in California, that property in the name of the wife alone was presumed to be her separate property. On the other hand, there was no such presumption for the half in the name of the husband, so it would be community property. The result in the above case in California has been modified by statute, but it does illustrate the problem. In California, a reference in the deed to the tenants in common as "husband and wife" will reinstate the community property presumption.

Assuming the parties want to assure classification of the tenancy as community property, the tenancy in common should be avoided, or if that is not possible (the jurisdiction does not recognize a community property form of title), by an agreement between the spouses which meets state law requirements indicating the property is still community.

JOINT TENANCY WITH RIGHT OF SURVIVORSHIP

The form of title which causes the most difficulty with characterization is a joint tenancy between the husband and wife "with right of survivorship." In addition to conferring upon the co-owners the rights of tenants in common discussed above, this form of ownership provides that upon the death of either joint owner, the property will pass entirely to the survivor by operation of law, i.e., regardless of the will or estate plan of the deceased owner, and without probate.

While the joint tenancy form of ownership has been popular as an apparently simplified method of transferring property at death, it is clearly inconsistent with the rights of spouses in community property. The right of survivorship is inconsistent with the right of each spouse to dispose of his or her share of community property at death.

The problem is that for various reasons, including tax considerations, it may be highly desirable to retain the community property form of ownership. Also, in the case of divorce, community property classification may be much more desirable than the equal co-ownership of joint tenancy, which has led to a statute in California reclassifying joint tenancy property as community property for divorce only.

Most of the community property states have dealt with this problem in one way or another. One solution is to create a hybrid title, which is "community property with right of survivorship." By case law, New Mexico simply concludes that a joint tenancy between a husband and wife will be characterized as "community property with of survivorship" Most other community property states, as well as Wisconsin, have either adopted a hybrid form of title, or a procedure under which a husband and wife can agree that items of community property will pass by right of survivorship. The one state which has not solved this problem or even addressed it is California. Under California law, joint tenancies between spouses is treated as community property for divorce purposes only.

The issues raised by the joint tenancy form of ownership, and in particular, the tax and estate planning consequences of that form of title, will be further considered in a subsequent section.

JOINT OR PAY ON DEATH ACCOUNTS

Joint or pay on death bank accounts are similar in some respect to joint tenancies, since they do provide for disposition of the funds in the account on the death of the owner or co-owner without the necessity of probate administration. However in most jurisdictions, the presumption of join ownership will not apply. In California, if a husband and wife are parties to a joint, pay-on-death or trust account, it is presumed to be community property in the absence of tracing or a written interspousal agreement. This is derived form a provision in the Uniform Probate code, which applies in many states.

AL – WHAT IS THE TEXAS LAW ON THIS? CAN YOU EXPAND ON THE UNIFORM PROBATE CODE ISSUE?

AGREEMENTS BETWEEN SPOUSES – TRANSMUTATION

In virtually all community property states, husbands and wives may enter into contracts with each other relating to their community and separate property, either already owned, or acquired in the future. This may also extend to management rights.. To the extent such agreements change community to separate property, or visa versa, these agreements result in a "transmutation" of the property. This can also be done through interspousal gifts. In effect, a "transmutation" is any agreement or transfer that changes the character of the property. Agreements may be entered into before or during marriage. A third type of agreement is a property settlement agreement in connection with a divorce, which is covered subsequently.

AL – I HAVE NOTHING ON THE IMPACT OF PROPERTY SETTLEMENT AGREEMENTS, BUT YOU PROBABLY DO.

It will be the task of the estate planner to determine whether or not the clients ever entered into an interspousal agreement. If entered into in another state, there may be an issue of enforceability of the terms of the agreement in a different state.

AL – I HAVE NOTHING ON THIS, BUT IT SEEMS IT WOULD BE AN INTERESTING ISSUE.

PRENUPTIAL AGREEMENTS

An agreement between parties contemplating marriage relating to property rights is referred to as a "prenuptial" or "antenuptial agreement." Such agreements can transmute, i.e., change the character of, separate property or community property to be acquired during marriage. They can also characterize or recharacterize the earnings of either spouse during marriage as separate property. The formal requirements for such agreements vary widely among the states. Virtually all states require the agreement to be in writing. Some may require greater formality, such as notarial acknowledgment. If the agreement affects real property, it may be necessary to record it. However, many courts have construed these formal requirements to be inapplicable to those elements of the antenuptial agreement, which are actually carried out during marriage. Thus an oral antenuptial agreement may be enforced if there is a subsequent delivery of a deed or bill of sale to carry it out. Further, even informal acts of the parties have been held sufficient to carry out the terms of an oral agreement.

Even if the prenuptial agreement complies with the necessary formalities, the courts may refuse to enforce it. For example, such an agreement will generally not be enforced if it promotes divorce.

Example: The parties entered into a prenuptial agreement under which the wife would receive a house and certain other property in the event of a divorce. This was unenforceable.

The extent to which such an agreement can be set aside on the basis of oppression or unfairness is less clear. Some states, including California, require the parties to either make a full disclosure of their property and liabilities before the agreement is made, or obtain a waiver of such information by the other party. Where an attorney in negotiating the agreement represents only one of the parties, this may lead a court to assume there was fraud or oppression, although many such agreements are enforced. It can also be argued one party exerted "undue influence" over the other. In general, the law permits the parties to bargain more or less freely. Also, the marriage or promise of marriage is generally sufficient to support the contract – it is not necessary to establish either party received some other form of consideration for it.

POSTNUPTIAL AGREEMENTS

A husband and wife may enter into any agreement or transaction with each other and with third persons regarding property as if they were not married. Generally speaking, a marriage couple may, with or without consideration, agree to "transmute" community to separate property, separate to community, or separate of one spouse to separate of the other. When they are dealing with each other, they are subject to fiduciary limitations because of their confidential relationship. Also, such a transmutation may be subject to laws governing fraudulent transfers that are intended to defeat creditors.

There are no particular formalities required for postnuptial agreements; oral agreements between a husband and wife have been fully enforced under this rule, at least where personal property is involved. Several states require a written agreement to transmute real property during marriage. There is some confusion in the cases as to whether oral agreements of the spouses must be executed, i.e., the parties must actually take other action indicating that they have carried out the terms of the oral agreement, such as changing title to assets, transferring funds, etc. Certainly oral agreements are hard to prove, and if the parties have taken certain steps to carry out the oral agreement, this would be strong evidence that it exists. However, it is not clear that such steps would be necessary to establish the validity of the oral agreement itself.

The form of title to property may be characterized as a transmutation, if it changes either the separate or community nature of the property itself, or the source of its acquisition, i.e., from separate or community funds. If the transmutation requires a form of writing, it should be determined whether or not the parties actually executed an agreement relating to or approved the form of title.

INTERSPOUSAL GIFTS

The status of property may be determined or adjusted by gifts between husband and wife, who can achieve transmutations of community property to the separate property of one spouse, or transmutations of separate property to community property. Consistent with other transactions between spouses, such gifts may be expressed or may be implied by conduct of the spouses. For example, an interspousal gift may be implied where community assets are used to improve the separate assets of one spouse, or the separate assets of one spouse are used to improve community assets. However, intent to make a gift must be proved.

If a spouse makes a gift partly to a spouse and partly to a third person, a question may arise as to whether the nonconsenting spouse can take his or her gift and invalidate the gift to the third person. Case law in general indicates that where death or dissolution terminates the marriage, the nonconsenting spouse may be forced to an election either to invalidate the entire gift or to affirm the entire gift.

CLASSIFICATION OF SPECIFIC ASSETS

This section will deal with classification of specific assets of particular concern to estate planners.

LIFE INSURANCE OTHER THAN TERM OR GROUP TERM POLICIES

Where the property in question is a life insurance policy, the first consideration is whether or not it is an investment type of policy or a term type of policy. For these purposes, an investment policy includes any policy with any cash value, universal policies, adjustable life policies, etc. Where the policy has investment characteristics, community property state will generally treat it like any other form of asset, and trace the source of payment for it, in this case, premium payment. If the policy is purchased with traceable community funds, the policy and all rights in the policy will constitute community property. This would include the proceeds at death, the cash surrender value, and the source of policy loans. Where the premiums are paid with separate funds, all rights in the policy will constitute separate property. Where an employer pays the premiums, most courts will characterize them as community property, rejecting an argument that such premium payments are gifts to the employee; therefore separate property.

As in the case of most items of property, the real issue will be characterization of the policy rights where premiums are paid partly with traceable separate funds and partly with traceable community funds. In general, the answer will depend on whether the state in question follows the inception of title theory, or the apportionment theory.

A good example of application of the inception of title approach is McCurdy v. McCurdy, 372 SW 2d 381 (Texas, 1961). The policies in question were issued to the husband before his marriage, and made payable to his estate. One was "converted" after the insured was married. The court held the proceeds were part of the insureds separate property estate, with a right of reimbursement for premiums paid with community funds. As already noted, California specifically follows the apportionment approach.. Louisiana follows the inception of title approach, with a reimbursement of premiums paid with community funds.

AL – I AM SURE YOU WILL WANT TO COMMENT ABOUT THE STREET CASE

Example: Harry Smith, a single person, acquired a $500,000 ordinary life insurance policy, paying the premiums from his earnings. He named his mother as beneficiary. He married, and continued the premiums from his earnings. He died a few years later, having never changed the beneficiary designation. The facts show that $5,000 in premiums was paid prior to the marriage and $15,000 in premiums was paid during his marriage. A dispute over the proceeds has arisen between Harry's mother and his wife.

In an inception of title jurisdiction, the argument will be made that the proceeds of the policy are entirely separate property, payable to Harry's mother. His wife could probably claim reimbursement of the community funds to pay premiums, possibly with interest, depending on the jurisdiction. An apportionment state would decide that since 25% of the premiums were paid with separate funds, and 75% with community funds, Harry's mother would receive 25% of the proceeds as beneficiary. 75% of the proceeds would be community property, and Harry's wife should be able to assert a community claim to at least one-half of the balance of the proceeds.

In California, insurance on the life of one spouse payable to the other spouse as beneficiary will be treated as the separate property of the beneficiary upon death of the insured spouse, even if the premiums are paid with community funds and the policy is clearly community property. The beneficiary is treated as owner of his or her one-half community interest, and is treated as receiving the other half as gift from the other spouse which becomes complete on the death of that spouse. Wisconsin follows a similar rule.

Commentators often suggest there may be a different rule, which would provide that to the extent the payment of premiums produces a cash surrender value, that is an asset which would be apportioned on the basis of the portion of premiums paid with community funds and the portion paid with separate funds. This would follow the apportionment view. However, if the issue were the community or separate rights in the policy on death, reference would be made only to the last premiums paid before death. This rule, much like the one generally applied to term insurance, discussed in the next section, argues that the "pure" death benefit is attributable only to the last premium paid. However, this ignores the fact that ordinary life insurance provides for level premiums, and that the policy will generally remain in force regardless of medical condition. Also, there is generally a right to borrow against the policy. This suggests the early premiums do contribute to the ultimate death benefit, and could even be viewed as a prepayment of future premiums.

If the life insurance policy was one created by the action of the federal government, then regardless of its investment characteristics, federal law may control its classification under the federal preemption rules.. If the policy in question is a National Service Life Insurance policy, federal law controls over community property law, and the insured may designate a beneficiary for the entire proceeds, regardless of the community interest of the insured' s spouse. Wissner v. Wissner, 338 U.S. 655 (1950). It is not clear the extent to which the federal rule relating to designating beneficiaries will extended to other federal employee insurance programs, such as federal employees' group life. California held that it not in Carlson v.Carlson, 11 C.3d 474 (1974). Also, California has sought to limit the Wissner rule to its specific facts. See Estate of Allie, 329 P2d 903 (1958). Under the facts of that case, the policy was payable to the insureds estate. In 1974, the California Supreme Court held that although it could not award an interest in such a policy to the noninsured spouse in a marital dissolution, it could award other community assets of equal value. In re Marriage of Milhan, 13 C.3d 129 (1974). But the U.S. Supreme Court, in Hisguierdo v. Hisguierdo, 439 U.S. 572 (1979), expressly ruled that this offset technique could not be used in the case of Railroad Retirement Act benefits. The California Supreme Court has subsequently reaffirmed its position and applied it to G.I. Instance in In re Marriage of Milhan, 27 C.3d 765 (1980), holding that the Hisquierdo rule did not apply to such insurance.

However, the U.S. Supreme Court held it did extend to Serviceman's Group Life Insurance in Ridgway v. Ridgway, 454 U.S. 46 (not involving a community property state). This case is interesting in that a private carrier, not the federal government, provides the insurance. This raises a serious question as to whether or not the California cases will hold up.

Under the apportionment rules, there will still be several problems where it is necessary to determine the community and separate property interests inn the policy before the death of the insured. The "value" of the policy will be its cash surrender or investment value, and in apportioning that, it is not clear whether or how the build up in the value will consider the return on investment of premiums.

TERM LIFE INSURANCE

Where term or other no cash value insurance is involved, the question is whether or not the status of the policy as community or separate will depend on all of the premiums paid, or only the last premium. A majority of the community property states, Washington, Idaho, New Mexico, and Arizona, only look to the last premium theory is that prior premiums only paid for protection during the period covered by that premium. Texas law is not entirely clear – at least one circuit has interpreted Texas law as providing that each premium payment is not a new inception of title, really using an allocation method. Estate of Cavenaugh v. Comm., 51 F3d 597 (5th Cir. 1995).

California law is similarly unclear in this area. For many years, California applied a strict apportionment theory to premiums paid on term insurance. Now one California appellate court has held that the last premium used, unless the insured has become uninsurable. Estate of Logan, 236 Cal Rptr. 368 (1987). Another California appellate court disagrees. In re Marriage of Gonzalez, 214 Cal Rptr 634.

Wisconsin applies a unique set of rules. Pollicies issued during marriage are marital property regardless of the source of premium payment. Policies issued before marriage are part individual (i.e., separate) and part marital if any premium is aid from marital property. However, the apportionment is based on the time period the policy is in effect after the first premium is paid from marital funds.

DISABILITY AND WORKERS COMPENSATION

The status of disability benefits is often unclear. If they were treated as personal injury damages, they would appear to be separate property, at least in most community property states. See ¶385. Further, if the spouses are involved in a divorce or separation, and post divorce or separation earnings are separate property, there is a strong argument that such benefits are in lieu of future earnings, which would be separate property.

California has dealt extensive with disability issues. Where a disability pension included normal retirement benefits, the California Supreme Court indicated that the community or separate status of the normal part of the pension would be determined under the rules relating to pensions; the excess under rules relating to disability. In re Marriage of Stenquist, , 21 C.3d 779, 145 C.A.3d 424. Under the Stenquist rule, where an employee was forced to take early retirement because of injury, and had not vested in the pension plan, it was treated as entirely a disability benefit. However, another court extended Stenquist to a nonvested pension and allocated an interest to the other spouse as normal retirement If the disability is aggravated in the future and benefits change, this allocation must be adjusted. For an example, see In re Marriage of Stier, 178 C.A.3d .

As noted above, classification of disability benefits may center on the issue of whether the benefits are really compensation for loss of future income. If so, and the parties are separated or divorced, the pension may be treated as separate property, if future earnings would be separate property, as would be the case in California. See ¶3.95. The law in this area in other community property states is unclear. Conflicting decisions in Louisiana held in one case that all such benefits after separation are separate property of the disabled spouse, while another case, the court held that they would be community if paid from a fund traceable to community labor and earnings. Decisions in Texas, Idaho, Washington and New Mexico suggest these benefits paid after marriage may be community property under some circumstances such as where there is an argument that they replace pension benefits, or are paid from a community based fund. Wisconsin applies a presumption that such payments are the same as damages for pain and suffering, and should be separate property.

The California Supreme Court has held V.A. disability benefits would be community property. In re Marriage of Milhan, 27 C.3d 765. However, in view of the federal preemption rules , this appears to be questionable.

EMPLOYEE BENEFITS OTHER THAN RETIREMENT PLANS, INCLUDING STOCK OPTIONS

There are a variety of employee benefits which may be earned before, during, or after marriage, and will be the subject of classification. It is generally assumed all of these benefits are compensation, not gifts from the employer. Therefore, to the extent they are earned during the marriage, they will be community property. This presented few problems in the case of most benefits, but the problem, as already discussed, will be those benefits which will be enjoyed in the future, which could be after the community is terminated by divorce or death. One example is a discretionary bonus – is it paid in recognition of past services, or as an incentive to continue employment with the company? The cases are uncertain. A post-divorce "gift" from employer to employee may be a community asset. Downer v. Bramet, 152 C.A.3d 837. In re Marriage of Horn, 181 C.A.3d 540, a lump sum severance pay based on number of NFL seasons paid was held to be community property.

Stock options present a unique series of classification issues. For one thing, there will be an issue as to whether or not the option is granted in consideration of past services, an incentive for continued employment, or both? Even cases in the same jurisdiction, California, have reached different conclusions on this point. In Marriage of Hug, 201 Cal Rptr. 676 (1984), the court determined that the option was both in recognition of past services and an incentive to keep the key person with the company. The court apportioned the value of the option based on the potion of the total period of time form the date of employment to the exercise date that the employee was married. This is referred to as the “time rule”. It has been followed in the case of stock options by Washington and New Mexico.

This issue was also raised in Marriage of Nelson, 177 C.A.3d 150. The trial court used a time rule similar to Hug, but first broke the "options" into three categories: those granted and exercisable before separation, which were entirely community; those granted before separation and exercisable after, which were part community/part separate; and those granted after separation, all separate. As to the second category, the court used a formula in which the numerator was the total months between grant and separation, and the denominator the months between grant and exercise.

A similar formula was used in Marriage of Harrison, 179 C.A.3d 1216, except the court referred to "vesting". In addition to qualified options, husband also had restricted stock covered by IRC § 83. The appellate court indicated the formula should have referred to the date that restrictions would lapse rather than the date of vesting. In both of these cases the courts reduced the value for income tax that would be incurred on the options and stock. The correctness of this is not clear.

Fringe benefits are not gifts, and to the extent the right to them is earned during marriage, they are community property. But if they are earned during employment prior to marriage, they are separate property, even though the benefit may actually be received during marriage.

BUSINESS OR PROFESSIONAL GOODWILL

In general, community property states have concluded that if there is goodwill involved in a business or professional practice that accumulated during marriage, it is a community asset. However, Texas draws the line in the case of professional goodwill, holding that such goodwill is personal and not a divisible community asset Nail v. Nail, 486 SW2d 761. This approach has been followed in Louisiana and Wisconsin.

The valuation of business or professional goodwill is a difficult area. In general, it is based upon the going concern value of the professional practice. In the case of divorce, , the fact that there is an underlying agreement among the owners that the interest of a deceased or retiring participant may be purchased without any payment for goodwill does not control the value, since the participant may continue in the business or professional practice.. the provisions of the agreement would of course be relevant in the case of death or the actual withdrawal of the participant from the business or professional practice.

At least in theory, the value of the goodwill cannot include the postmarital efforts of either spouse. However, in several community property jurisdictions, particularly California, earnings prior to dissolution can be used as a factor to determine the goodwill and value at the time of dissolution. In other words, the use of capitalized earrings formulas to value goodwill may be acceptable, even though the clear assumption of such formulas is that the prior earrings are also a measure of the future earnings and future earnings are not supposed to be a factor in valuation of goodwill. These rules apply to sole proprietorships, partnerships, and interests in professional corporations.

There seems to be a general assumption that all closely held businesses and professional practices of necessity include an element of goodwill. This is clearly not the case. If it is established that the business or practice is producing no more than reasonable compensation and/or return on investment, there is no goodwill.

COMMUNITY PROPERTY AND RETIREMENT PLANS

Community property interests in qualified retirement plans are one of the most difficult assets to classify under the community property system. Among the various issues to consider are the following:

1. Do the plan benefits have to be "vested" in order to create enforceable comminute property rights?
2. How are these benefits to be allocated between the periods the spouses were married and living together and periods when they were not, i.e., before marriage and after separation or divorce?
3. If the spouse who is not the participant in the plan dies, will his or her community property rights survive death?
4. If the spouse who is not a participant in the plan retains an interest after divorce but before benefits begin, have do post divorce events affect the rights of that spouse?
5. To what extent does federal law "preempt" community property rights in retirement plans?

THE VESTING REQUIREMENT

In the case of retirement benefits, whether formal pension plans, or less formal deferred compensation plans, there are a variety of conditions and contingencies which may affect the amount of the benefit, or whether in fact there will be a benefit at all. These may relate to "vesting" in the plan, meaning an essentially unconditional right to receive benefits. Most community property jurisdictions recognize that to the extent a pension benefit is earned during the marriage, it is community property, even though it is not vested and is subject to forfeiture. Even where the pension right is vested, there is no right to receive benefits under its terms until the conditions for retirement have been met, and its value is often uncertain.

Even in those community property states which follow inception of title, it is generally agreed that a pension benefit is earned during the entire period of employment, and that there is a property right before the plan is vested, and before the participant is entitled to receive benefits. This means that inception of title or vesting of title jurisdictions will in this case apply an apportionment approach similar to that followed in states such as California or Washington

ALLOCATION OF PENSION BENEFITS

Despite the complexity of valuing pension rights earned over a period of time, in which case the nature and extent of the benefits can change greatly from year to year, the courts generally treat the pension benefit as a single asset, and do not attempt to value it on the basis of the year to year incremental change in value. This is admittedly an over simplified approach, but has the advantage of relative simplicity. The result is to apportion the total benefit based on the time period during which the pension was earned, the so-called "time rule."

Basically the time rule will allocate a portion of the total retirement benefit to the community based on the following fraction:

$$\frac{\text{Length of service during marriage}}{\text{Total length of service}} \quad \text{times the value of the retirement benefits.}$$

The courts have, however, indicated that the time rule is not always appropriate. It works best in the case of a defined benefit plan, where the participant will be entitled to a pension based on one or more factors, such as the length of service, and total direct compensation. The time rule has been applied, with variations, in California, Texas, Idaho, and Louisiana, In the case of the last three states, this produces an interesting result, and since they follow the rule that income e derived from separate property is community property.

Example: Under the provisions of the Acme company pension plan, an employee who works for the company at least 30 years will be eligible to retire at age 65 and receive a pension equal to 60% of his highest salary based on a five year average.

It is clear the time rule does not work as well in the case of defined contributions plans, where contributions are made to the plan by the employer (and possibly also by the participant) each year, credited to an account for that participant, and the participant will receive a pension benefit based on the total value of that account at the date of retirement.

Example: The Acme Corporation has a profit sharing plan, under which it contributes a certain amount each year, which is allocated among the participants based on a formula relating to the percentage the direct compensation of each participant bears to the total directly compensation of al participants. At retirement, the participant may draw a pension based on the then value of that account, including all income and gains allocated to that account.

Court decisions suggest that an insurance apportionment rule would be appropriate in some cases, i.e., the ratio of total plan contributions during marriage to total plan contributions. California , Idaho, and Louisiana have followed this approach.

Other cases have suggested the time rule is also inappropriate where the pension benefit is not based on years of service. For an example, see In re Marriage of Poppe, 97 C.A.3d 11 (1979), where the pension was based on awarding credits to the employee It should be noted that some cases which have applied the time rule have sought to adjust it to reflect the fact that pension benefits accruing after a divorce or separation are likely to be greater, since in most cases the compensation of the employee, which is the basis of the defined benefit pension, increases with an increase in years of service.

Even where the time rule is followed, there will still be questions on how the value the pension. The pension will be valued at the date of termination of the community by divorce or death, not the date the pension actually matures. The following is one common method of valuing defined benefit pensions:

1. First find the lump-sum value of benefits at projected date of retirement.
2. Discount based on mortality, interest and vesting to present value.
3. Apply the fraction under the time rule

THE IMPACT OF POST DIVORCE EVENTS ON THE NON PARTICIPANT'S RIGHTS IN THE RETIREMENT PLAN

While the law generally provides the spouse who is not the participant in the retirement plan has a community interest in it, it is not clear how this is to be valued. The simple formulas may operate unfairly for a variety of reasons, particularly if the value must be determined for purposes of property settlement on divorce, or to determine the value of the interest of the nonparticipant spouse who dies first. It is possible the pension will never be paid if it is not vested, or that the participant could take early retirement and receive less, or after retirement, and receive more.

In the Marriage of Brown decision, the California Supreme court set forth various methods that could be used to divide pension benefits. The courts normally prefer awarding the pension to the employee spouse, and assets of equal value to the other spouse. This of course raises the valuation issues discussed above. The rights are not vested at time of the property division if they are subject to a contingency. If the court can value that contingency, e.g., survival until a certain age, which could be evaluated by actuarial tables, it can divide the present value of those rights between the spouses.

If the court cannot divide the present value of the pension rights, it can instead prospectively award each spouse an appropriate portion of each pension payment when paid. Such an award of future pension payments will require the court to retain jurisdiction in the future. As in the case of life insurance, if the court elects to award the future payments, continued employment of one spouse will affect the prorata interest of each spouse in the pension payments.

There are various ways the court can enforce an order dividing pension benefits in the future. One spouse can be ordered to make payment of his or her retirement benefits to the other, but this is difficult to enforce. This in turn has led to the device of joining the employer or plan administrator as a party to the divorce, and attempting to obtain an order from the state court that would compel the administrator to make payments to an ex spouse at the appropriate time. While this has been vehemently resisted in many cases, where the plan is covered by the Retirement Equity Act of 1994, the state court can order the administrator to make payments to a former spouse. This is done through the issuance of a "qualified domestic relations order (QDRO)", which is discussed subsequently

POSSIBLE APPLICATION OF THE TERMINABLE INTEREST RULE

As discussed previously, some community property states apply the so-called "terminable interest rule" to interests of nonparticipants in retirement plans, and occasionally other assets. Simply stated, this rule means that where a non participant spouse, or no participant ex spouse is the first to die, his or her community interest in the plan is terminated. This possibility has a substantial impact on valuation of the interest at the time of divorce.

APPLICATION OF COMMUNITY PROPERTY RULES TO IRAS

Individual Retirement Accounts, or IRAs, are generally provided by IRC § 408. They arise in a variety of situations, and can also be the result of a rollover of benefits from qualified pension ad profit sharing plans. As an initial proposition, IRAs should be treated no differently than other employee benefits. In the case of direct contributions to IRAs before, during, or even after marriage, the general rule of apportionment should apply. This may raise interesting issues in inception of title or vesting of title jurisdictions where the account was initialed by one spouse prior to marriage, and additions were made to it from community funds during marriage. In apportionment jurisdictions, and in any jurisdiction where the IRA was created during the marriage, the account can generally be analyzed in terms of the ratio of total contributions to it, much in the same manner as interests in defined contribution retirement plans.

Where the IRA is the result of a rollover from a qualified retirement plan, the determination of the separate and community components may be difficult. In the case of qualified retirement plans, such as defined benefit plans, where the time rule is appropriate, it should be applied at the time of the rollover, when the amount of the benefit can be ascertained. In the case of defined contribution plans, straight allocation rules should apply..

Where an IRA is in whole or in part community property, there is a substantial question as to what rights the spouses have in the account. Although IRAs are not specifically covered by ERISA. However, there are express federal limitations on rights in IRAs. Only the participant can make withdrawals. Certain anti assignment limitations apply. Further, it is not clear whether or not the nonparticipant spouse who dies first can make a disposition of his or her interest in the IRA. The MacDonald decision which follows is an example of this issue.

Under the facts of the case, Estate of MacDonald v. MacDonald, 794 P. 2d 911 (California, 1990)a husband received a distribution from his pension plan, which was conceded to be community property, and deposited these funds into individual retirement accounts (hereinafter IRAs). The IRA accounts were established through the use of forms characterized as adoption agreements, which included a provision for designation of a beneficiary who would succeed to the account on the death of the owner/participant. Also included was a form for the consent of the owner's spouse to the beneficiary designation.

The instructions made available for the adoption form indicated that if the participant's spouse was not named the sole primary beneficiary, the spouse would have to sign the consent. The husband named as beneficiary a living trust which provided income for wife for life, remainder to his children from a prior marriage. His wife signed the consent which read: "Being the participant's spouse, I hereby consent to the above designation."

The wife left a will which bequeathed the residue of her estate to her four children. She was terminally ill when the consent was signed, and contemporaneously with that action, the husband and wife divided their other property into separate estates. She sold her half, and placed the proceeds into a separate account. When she died approximately six months later, the executrix of her estate sought to assert a community claim against the IRA accounts.

The trial court held that the signature of the deceased wife to the consent form constituted a waiver or transmutation of her community rights in the IRAs, which in effect resulted in a transfer of those rights to the husband. Thus, the wife's community interest in the IRAs was transmuted into the separate property of the husband.

This determination was reversed on appeal, Estate of MacDonald v. MacDonald, 213 Cal. App. 3d 456; 261 Cal. Rptr. 653 (1989); and the Supreme Court agreed with the appellate court. The effect of this decision was that the consent of the wife was ineffective for any purpose, and that the personal representative of her estate could claim her community interest in the IRA, despite clear evidence she intended that it pass in accordance with the beneficiary designation in which she joined.

FEDERAL PREEMPTION OF STATE COMMUNITY PROPERTY LAW

As discussed previously, the doctrine of federal preemption is applied in situations where it is determined that under the Supremacy clause in the U.S. Constitution, federal law preempts state law. In other words, where the federal government "occupies the filed" through federal legislation, state law will not control. In California, this doctrine has most often been applied in cases where community property rights are not consistent with controlling federal law. A good example is Boggs v. Boggs, discussed subsequently,

However, the doctrine of federal preemption has been most frequently applied to retirement benefits. One of the first examples is Hisquierdo v. Hisquierdo, 454 U.S. 64, where the Supreme Court held that federal law controlled all rights in Railroad Retirement Act benefits, including community property rights. A similar result was reached as to military pension s in McCarty v. McCarty, 453 U.S. 210. In both of the foregoing situations, Congress changed the law to give at least limited recognition to community property rights. Federal preemption has also been applied to social security benefits, Marriage of Hillerman, 109 CA 3rd 334.

ERISA PREEMPTION

The Employee Retirement Income Security Act of 1974, or ERISA, regulates most, but not all, employee retirement plans and benefits. Among other things, it mandates that interests in such plans cannot be assigned or transferred in a manner inconsistent with its requirements. It clearly states that its provisions "shall supercede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan. 29 USC § 1144(a). By definition, ERISA does not cover individual retirement accounts (IRAs). This had led to serious concern over whether or not federal law so dominates the pension field, at least insofar as ERISA covered plans are concerned, that there are no community property rights!

While this language is certainly broad, the Supreme Court refused to hear an appeal of a California case, Carpenters Pension Trust Fund v. Campa, 89 CA3d 113, which involved a transfer of a community interest in a qualified plan to a spouse in connection with a divorce. In rejecting the appeal, the Supreme Court specifically indicated that there was no federal question involved. However, this should be read in light of the Boggs decision, discussed subsequently.

REQUIREMENTS OF REACT

The Retirement Equity Act of 1984, Pub L No 98-397, 98 Stat.. 1436, provides that where a plan participant was married, and had at least one hour of service or paid leave on or after August 23, 1984, the accrued benefit must be paid to a retiree in the form of a joint and survivor annuity to the participant and spouse. IRC §§401(a)(11)(A), 417(b). In the case of defined benefit plans, these rules apply to benefits vested at death; in the case of defined contribution plans; they apply to all nonforfeitable benefits, including insurance proceeds. Reg §1.401(a)-20, Q&A-12. This is a joint and survivor annuity with the survivor annuity at least 50 % of the amount payable while both spouses are living. Further, if the vested participant dies before the annuity starting date, leaving a surviving spouse, that spouse must receive a "qualified pre retirement annuity." IRC §§401(a)(11)(A)(ii), 417(c).

In the case of defined benefit plans, the annuity is based on what the participant would have received on retirement. In the case of defined contribution plans, the survivor annuity must be worth at least 50 % of the nonforfeitable account balance. This means that, in the case of defined contribution plans, the participant can direct 50 percent of the value at date of death to another beneficiary, such as a credit shelter trust.

"Spouse" includes only persons married to the employee for at least one year before the annuity starting date, or date of death. IRC §417(d). This automatic survivor annuity must be available in all pension plans, and in all defined contribution plans (other than pension plans) which provide annuity options. If there is no annuity option, the surviving spouse will be entitled to any death benefit. No consent is required for designation of a beneficiary after the death of the survivor.

The changes made by the Retirement Equity Act specifically override any contrary provision of law, or any other beneficiary designation. Covered are all pension plans, including self-employed pension plans, but not IRAs or SEPs. Reg §1.401-20 Q&A-3. There is no doubt they preempt or supersede community property laws to the contrary.

REACT permits the parties to elect to waive the survivor benefit. From the standpoint of pre mortem planning, the use of a waiver, particularly in the case of defined benefit plans, allows more flexibility. In some cases, it appears that there are insufficient assets other than the plan benefits to take full advantage of the unified credit if a survivor annuity is mandated. Note the waiver does not constitute a taxable gift. In view of the broad effect given to agreements between spouses in community property states, it can certainly be argued that such a waiver will restore community property rights in the plan.

The conclusion seems to be that where an employee spouse dies first in a community property state, leaving plan benefits to someone other than the non-employee spouse, who executes the appropriate waiver under IRC § 417, the non-employee spouse has made a taxable gift of his or her community interest in the benefits. However, if the plan benefit were the separate property of the deceased spouse, that waiver results in no gift tax consequences to the surviving spouse.

Assuming an appropriate waiver of the survivor benefit was not obtained pre mortem, the only effective planning which may be done post mortem is a waiver of the survivor benefit by the surviving spouse, This subject is discussed in detail in a later section.

THE ABLAMIS AND BOGGS DECISIONS

Two federal court decisions, one in the Ninth circuit court of Appeals, dealing with California community property law, and the other in the U.S. Supreme Court dealing with Louisiana community property law, indicate the extent of federal preemption of community property rights in retirement plans.

In Ablamis v. Roper, 937 F2d 1450 (9th Cir, 1991) , Mr. Ablamis was a participant in two retirement plans, in which a large percentage of the contributions were made during his marriage to Mrs. Ablamis. The first plan was created in 1969. The couple was married from 1972 until the death of Mrs. Ablamis in 1988. The second plan was created in 1973. Therefore, it seems clear most or all of the retirement benefits would be characterized California community property. The will of Mrs. Ablamis left all of her share of community property into two trusts, one for the exclusive benefit of her children from a prior marriage, the other with a remainder to those children. Based on all of this, the estate of Mrs. Ablamis asserted a claim against the retirement plans, and the trustee brought an action in federal district court to establish that Mrs. Ablamis's estate is not entitled to any interest in the plans.

In a 2 to 1 opinion, the Ninth Circuit held that on the basis that REACT preempts any state law which would permit a nonparticipant spouse to bequeath an interest in a retirement plan. The court discusses the background of REACT, which was to provide protection to either former spouse (or other dependents) in the case of divorce, and widows or widowers in the event of death. Automatic survivor benefits are mandated under 29 U.S.C. §1055, at least equal to 50 % of the participant's vested benefit. This provision can be waived only by written agreement of both spouses, not applicable here.

There are strict spendthrift and anti assignment provisions, with an express statutory exception for state court orders (qualified domestic relation orders or QDROs) authorizing payments to an alternative payee, such as a former spouse or for support of dependent children.

The majority analysis holds that even assuming Mrs. Ablamis had a community interest in the plans she could transfer at death (language in the majority opinion suggests the court was not convinced that is California law), there are no exceptions under REACT for such bequests.

The Ninth Circuit noted that, prior to REACT, several California decisions and at least one Ninth Circuit decision (by inference) Carpenters Pension Trust v. Kronschnabel, 632 F.2d 745 (9th Cir. 1980) permitted an assignment of community interests in a divorce. However, it found that as amended by REACT, ERISA now preempts all orders relating to transfers of interests in retirement plans covered by ERISA, regardless of contrary state law.

In Boggs v. Boggs, 117 S. Ct. 1954 (1997), the Supreme Court held that the Employee Retirement Income Security Act (ERISA) preempts state community property law, at least to the extent a non participant spouse would have a power of testamentary disposition over undistributed pension benefits. When the first spouse of Issac Boggs, the plan participant, died in 1979, she left a usufruct interest under Louisiana law in her share of community property to her sons. Issac remarried, and at his retirement in 1985, he received the following retirement benefits:

1. A joint and survivor annuity under his employer pension plan.
2. A lump sum distribution from a savings plan, which he rolled to an IRA, and from which he commenced receiving annuity payments.
3. Shares of stock under an Employer Stock Ownership Plan (ESOP).

On his death, the sons asserted a claim against all the above assets, including a survivor annuity paid to his second spouse.

In holding that there is federal preemption of all of the above benefits, the 5 to 4 decision is broad enough to raise a question as to whether or not such benefits, including IRAs, will be classified as community property for transfer tax purposes. The opinion holds that insofar as a surviving spouse would be entitled to a survivor annuity under ERISA, as amended by the Retirement Equity Act (REACT), a non participant spouse (or for that matter, a participant spouse) can do nothing to diminish or defeat this right.

On this question of the rights of the sons in the survivors' annuity mandated by REACT, the decision is really 7-2, as two of the dissenters agreed that there is clear preemption insofar as the mandated survivors' annuity provisions are concerned. This is in effect the position taken by the 9th circuit in Ablamis.

However, the 5-4 majority applies a much broader broad preemption rule under ERISA §1144(a), holding that if there is a conflict between state law and ERISA, or if state law "frustrates" the objects of ERISA, state law is to be disregarded. Based on this, the 5-4 majority holds that preemption also operates to defeat a claim against an annuity paid to the participant from the IRA rollover and the ESOP stock. The court also held that an attempted testamentary disposition is contrary to the anti-alienation provisions in ERISA, which it applied broadly. It applied preemption to all "undistributed pension benefits," which apparently includes IRAs and even the ESOP stock.

The dissent concedes the testamentary disposition cannot affect the rights of the participant or his second wife under the survivors' annuity rules, except as to any amounts undistributed at the death of the survivor. However, the dissent argues that a Louisiana court could have awarded the sons other community assets of equivalent value. In addition, the dissent makes the point that the IRA benefit and the company stock were not covered by the survivors' annuity provisions.

If this analysis is correct, and the participant is the first to die, 100% of the IRA would be included in his or her estate, and a marital deduction could only be claimed if a qualifying interest passed to the surviving spouse either by beneficiary designation or, if the benefit is payable to a trust or estate, it is subject to funding under a marital deduction formula. If the nonparticipant spouse is the first to die, nothing would be included in his or her estate, and the entire benefit will be subject to estate tax in the survivor's estate.

Recognition of community property rights in qualified plans and IRAs for federal tax purposes

It has always been assumed that community property laws apply to all forms of employee benefits, including those regulated under federal law. Section '1311 of the Taxpayer Relief Act of 1997 indicates the federal estate tax marital deduction is specifically available for a non participant=s community interest in an annuity where he or she predeceas
es the participant, and the interest passes to the participant. Effective for decedents dying after the date of enactment. However, the Statement of the Managers relating to this provision indicates there was no intent to modify the Supreme Court decision in Boggs v. Boggs, 117 S. Ct. 1954 (1997). Therefor, it is important to consider what the court did in that case.

The Tax Reform Act of 1986 repealed 2517(c), which generally held that a transfer of a non participant spouse's community interest in a qualified plan to a third person did not constitute a taxable gift. Compare that with new 2503(f), which provides that a failure of a spouse to assert a right to a survivor annuity in a qualified plan is not a taxable gift. The conclusion seems to be that where an employee spouse dies first in a community property state, leaving plan benefits to someone other than the non employee spouse, who executes the appropriate waiver under ' 417, the non employee spouse has made a taxable gift of his or her community interest in the benefits. However, if the plan benefit were the separate property of the deceased spouse, that waiver results in no gift tax consequences to the surviving spouse.

Subject to the impact of the Boggs and Ablamis decisions, the IRS has consistently recognized that community property interests will be found in qualified plans and IRAs.

In a series of private letter rulings issued before and after REACT, the IRS has never taken the position that federal preemption has the effect of eliminating the community property rights of a nonparticipant spouse.

In LTR 8040101, the estate included community property rollovers from the deceased's participants pension and profit-sharing plans. , the executor included a one-half interest in the IRAs in the decedent's gross estate. Service has ruled that the classification of the IRA interests is a question of state law and has accepted the executor's inclusion of the one-half IRA interests in the decedent's estate. The Service also ruled that the IRA trustee can distribute the IRA amounts to the decedent's legatees and that the IRA amounts, as distributed, are includible in the legatees' gross income.

LTR 8943006 held that a nonparticipant's community interest in a pension plan was included in her estate even though it terminated on her death under state law - it is deemed to pass to the surviving spouse in any case under REACT (and would be eligible for the estate tax marital deduction).

In LTR 9018002, involving Texas law, husband and wife were both participants in a qualified profit sharing plan. The wife died without designating a death beneficiary. Under the plan, the committee, including husband, could direct payment of the death benefit, and he directed the wife's community one-half to a testamentary trust, along with the wife's community interest in his plan. The IRS, noting this was a pre-REACT situation, held that each spouse had a community one-half interest in each plan under state law, and that was respected for tax purposes. However, the husband also had a general power of appointment over the wife's one-half of her plan, since he was in a position to designate a beneficiary. LTR 9234024 approved the apportionment of community property IRAs between the spouses. LTR 9321035 recognized the division of a decedent's community property IRA between a QTIP trust and a surviving spouse. LTR 9344027 involved a rollover from a community interest in a qualified plan to IRAs, one-half in the name of each spouse under a private separation agreement. This was not a taxable distribution.

In LTR 9427035, an IRA account was classified as community property, and the 50 % interest of the surviving spouse passed to a survivor's trust she could revoke. She did so, and the IRA was transferred by direct transfer to a new IRA in the name of the surviving spouse. This was a qualified rollover. Note the community nature of the account was established by a marital agreement, and that the surviving spouse was the sole remaining beneficiary of the survivor's trust.

In LTR 9439020, the IRS held an agreement to divide a community property IRA into two IRAs, each the separate property of one spouse, was not a distribution. Each will disclaim any beneficial interest in the IRA of the other. The ruling also holds the division is not a taxable gift. However the IRS refused to rule as to whether or not the division is a prohibited transaction, or on whether or not the nonparticipant spouse could dispose of his or her interest on his or her prior death. Note no part of the IRA is to be distributed to an account in the name of the nonparticipant spouse.

Husband and his deceased wife were both participants in a company §401(a) plan. Their benefits were community property. In the form 706, husband, as executor of the wife's estate, reported the wife's community one-half interest in each plan in Schedule I, the annuity schedule, claimed a marital deduction for the decedent's community interest in his plan, and asserted the beneficial interest in her plan passed to children and grandchildren. He also reported the additional estate tax under §4980A(d)(1) on her plan interest, but not her community interest in his plan.

In LTR 9441004, citing §4980A(d)(4), the IRS held the tax on the excess retirement accumulation is determined without regard to community property laws, and under the regulations, this covers community interests in both plan distributions and accumulations.

Thus, the husband correctly based the computation of the excess estate tax on 100 % of the value of the deceased spouse's plan, and none of his plan. The ruling does not discuss the reporting of the plan benefits and the claim of the marital deduction.

A surviving spouse proposes to direct the trustee of a decedent's pension plan to transfer her community property interest into an IRA. This was a qualified plan payable to a trust as primary beneficiary (with the consent of the spouse). Under the terms of the decedent's estate plan, the community interest of the surviving spouse was distributed to a trust over which she had a general power of appointment. In LTR 9633043, the IRS ruled the surviving spouse could be deemed the beneficiary as to her community interest, and the rollover was effective.

GIFTS OF COMMUNITY PROPERTY TO THIRD PERSONS

GIFTS OF COMMUNITY PROPERTY, IN GENERAL

Can one spouse make a gift of community property without the consent or joinder of the other? Under California law, a spouse cannot not make a gift of community personal property (or dispose of such property without a valuable consideration) without the written consent of the other spouse.. Interspousal gifts are exempt from the joinder requirement. There is no specific statutory provision for community real property, where California law requires a joint action in any case.

What constitutes written consent to a gift? It is not clear what is sufficient. However, signatures on a joint income tax return disclosing charitable contributions might be sufficient, and similarly, a gift tax return signed by the nondonor spouse would appear to be sufficient. But proper planning dictates that the written consent be obtained at the time the gift is made.

The importance of the written consent in California is illustrated by the decision in In re Marriage of Stephenson, 162 C.A.3d 1057. The husband had opened bank accounts for children naming himself as trustee for them, and also made transfers under the Uniform Gifts to Minors Act. In a divorce proceeding, the court found that wife had consented and approved of the transfers, although not in writing. It held that the transfers by husband in his name as trustee were revocable transfers in any case and could be recovered. Insofar as the transfers under the Uniform Gifts to Minors Act, the wife could set these aside as gifts to which she had not consented in writing. The Appellate Court overturned the referee's determination that she should be "estopped" from setting aside the gift as she had knowledge of it and consented. It should be noted that after this case was decided, California law was changed to exempt from the written consent rule gifts “mutually given” by the spouses.

Not all community property states require written consent or dual action to make all gifts. Texas, Arizona, and New Mexico, Louisiana, and Wisconsin all follow the civil law rule from Spain that “reasonable gifts” may be made by one spouse without the consent of the other. The difficult, of course, is in defining what is a “reasonable” or “customary” gift. Idaho, Nevada, and Washington follow the consent rule of California as to most gifts.

In those situations where a gift is made by one spouse without obtaining the required consent of the other spouse, what are the remedies of the nonconsenting spouse? Most jurisdictions hold that the gift is void, i.e., the nonconsenting spouse can set it aside. What is not clear is the extent to which the nonconsenting spouse, after obtaining knowledge of the gift, has to take action. If he or she does not take action in a reasonable time, he or she may be “estopped” from setting aside the gift. Note the court did not apply this doctrine in the Stephenson case. In Washington, such a gift is apparently void.

AFFECT OF TERMINATION OF THE COMMUNITY ON LIFETIME GIFTS MADE WITHOUT SPOUSAL CONSENT

While the nonconsenting spouse’s right to set aside a gift during the joint lives of the spouses generally applies to 100% of the gift, if the community is terminated, at divorce or death, the right to revoke the gift is limited. In the divorce situation, the usual situation is that the gifts are added back to the total value of community assets subject to division. If the court is making an equal division of community property at divorce, a usual remedy is to allocate the gift transfer entirely to the donor spouse, and allocate other community assets of equal value to the nonconsenting spouse. In this case, the donee is permitted to keep the entire gift. However, the divorce court frequently has the power to set aside the entire gift, particularly if the assets in question are needed to carry out an equal or equitable division of the community property.

At death, the general rule is that the nonconsenting spouse (or estate of the nonconsenting spouse, if he or she is the first to die) can set aside and recover only one-half of the gift. This is on the theory that each spouse has a power at death to dispose of one-half of the community property, so we will permit gifts to stand to the extent they do not interfere with that rule.

Note the planning and tax implications of the spousal consent rules in connection with gifts. If the appropriate consent is not obtained, is the gift complete or incomplete for federal income or transfer tax purposes? If it is only voidable, it is clear at least in California, that the donor spouse cannot rescind it. As a result, it is not a revocable transfer, at least insofar as the donor's community interest is concerned. On the other hand, is it really a complete transfer of the nonconsenting spouse's community interest? Clearly it is not. However, note that the nonconsenting spouse can set aside the entire gift during the joint lifetimes of the spouses.

An issue will arise if the gift is made both to the other spouse and to a third person without the required joinder or consent of the other spouse. In other words, if the nonconsenting spouse is one of the donees, and the donor dies, to what extent can the nonconsenting spouse set the gift aside? If the donor intended only to dispose of his or her one-half community interest, the nonconsenting spouse can clearly claim his or her one-half community interest and still claim as a donee as to the other half of the decedent.

For example, where the husband transferred some shares of community property stock to his brother and some to his wife, the wife was entitled to keep her shares and entirely set aside the transfer to the brother. The court said she had no knowledge of the transfers and, in any event, there was no evidence the husband was attempting to divide the community property. Ballinger v. Ballinger, 9 C.2d 330 (1937).

FIDUCIARY RESPONSIBILITIES

A husband and wife are deemed to occupy a fiduciary relationship in dealing with each other, and they also have a duty to act in good faith with respect to each other in connection with management and control of community property. However, the extent of that fiduciary responsibility varies greatly among the community property jurisdictions. At one extreme, a managing spouse is given broad power to deal with community property, subject to only some lied restraints to prevent him or her from taking advantage of the other spouse, much like the duties owed by any agent in acting on behalf of a principal, in this case, the other spouse. . For example, in Wisconsin, the law is that each spouse must act in "good faith" in dealing with the marital property. At the other extreme, the managing spouse is treated almost as s trustee, which imposes the highest standards of fiduciary care on the managing spouse. Thus California law makes express reference to the duties of a "trustee" in at least some management situations. It is also appropriate to refer to partnership law as a basis for determining the extent of the fiduciary duty, since husbands and wives are in a real sense "partners" insofar as management of community property is concerned.

Most community property jurisdictions would agree that one spouse cannot intentionally conceal material facts relating to value of community property from the other spouse Obviously, one spouse cannot conceal the existence of a community asset. Less clear are such issues as a duty to account to the other spouse on all matters relating to community property and probably debts and obligations as well. It has been suggested that since most community property states confer equal management on the spouses, there should not be a duty to account. However, again analogizing to partnerships, partners have a duty to account to each other for their actions in connection with the partnership, even though they share management and control and the same should apply here.

It should be noted that mismanagement or even negligence in management of community property is generally held not to give one spouse a cause of action for damages or restitution to the other. Thus when a reference to the duties of a "trustee" are made, this seems to extend potential responsibility far beyond what would generally apply the fiduciary standard with respect to community property. As already discussed, making gifts without the consent of the other spouse may breach the management responsibility of the donor spouse, and in fact is referred to as "misappropriation" of community property. On the other hand, California, which tend sot apply high fiduciary standards, has held that the fact the husband "squandered" community funds on alcohol was not a breach of fiduciary duty. It must be remembered that unlike a trustee, a managing spouse is also dealing with his or her own property.

Several cases in the past have suggested that if the spouses are in the process of separation or divorce, the fiduciary standards should be relaxed, and they should be treated as if they are dealing at arm's length with each other. The modern trend is to reject this position. In fact, it can be argued that the fiduciary standards should be strictly applied in this situation, particularly when a division of community property is imminent.

What are the remedies of one spouse against the other for breach of fiduciary duties? Unless the community has or is being terminated by divorce or death, there may be little that the injured spouse can do. Of course, in equal management states, he or she can seek to take over the management of the property. If the situation indicates the other spouse may be legally incompetent, i.e., unable to manage his or her own affairs (and therefore unable to manage community property), the aggrieved spouse can seek the aid of course through the appointment of a conservator or guardian for the other spouse. Louisiana has an express statutory procedure for partitioning or separating property, particularly the earnings of the aggrieved spouse, if the community is imperiled by the mismanagement of the other spouse this even extends to negligence. Wisconsin has a similar statute It may also be possible to collect damages from the spouse who has breached his or her duty in Arizona, California, and Louisiana. Wisconsin and California have useful statutes that permit a spouse to add his or her name to the title to community property, which has the affect of not permitting the other spouse to deal with it exclusively.

TERMINATION OF THE COMMUNITY BY DEATH

HOW DEATH AFFECTS COMMUNITY PROPERTY OWNERSHIP

Death not only terminates the community, it terminates the community property ownership. Under the law of all community property states, each spouse has a right to dispose of his or her one-half of the community property by will, along with his or her separate property. Note the special rule here for quasi-community property. In this case, the assets pass through probate administration. There are a variety of ways property can be transferred other than by will, so-called nonprobate transfers. These include joint tenancies with right of survivorship, beneficiary designations on insurance policies and for death benefits, pay on death accounts, and property passing by contract.

As a general proposition, each spouse is treated as owning one-half of each item of community property. This is referred to as the "item" theory. A different theory may apply in some situations, particularly in Arizona, where the spouses are treated as each having a one-half interest in the aggregate value of all community assets. This is not surprisingly called the "aggregate" theory.

In some cases, the first spouse to die attempts to dispose of more than his or her one-half interest in the community property. This may force the surviving spouse to an election under which he or she may either take his or her one-half of the community property, and forgo other bequests or transfers from the deceased spouse, or to take under the decedent's estate plan. Finally, it is necessary to determine the rights of creditors against the estate of the deceased spouse, and the surviving spouse

INTESTATE SUCCESSION TO COMMUNITY PROPERTY

While the statutes of each state must be consulted, as a general proposition, community property passes under a different set or rules than separate property. All of the nine states recognize that the surviving spouse is the owner of one-half of the community property. In other words, he or she does not obtain rights in that half through inheritance. However, whether or not the property must pass through probate administration varies among the states.

As a general proposition, California, Nevada, Idaho and New Mexico provide that if the deceased spouse does not dispose of his or her half of the community property by will, it passes directly to the surviving spouse. Arizona and Wisconsin do not follow this rule, and have detailed provisions for the distribution of both separate and community property of a decedent, which is treated essentially the same. The remaining states have more detailed provisions.

AL – HOW ABOUT THE GREAT STATE OF TEXAS?

THE ITEM THEORY

Based on case decisions, in California, Louisiana Texas, Washington, Wisconsin, and New Mexico follow the view that at the death of a spouse, he or she owns one-half of each item of community property. Only Arizona seems to follow the view that the deceased spouse can dispose of one-half of the aggregate value of the community property, leaving the surviving spouse with what remains. However, there is variation as to whether this only applies to asset which pass through probate, or also applies to assets passing outside of probate, such as life insurance payable to a named beneficiary, or employee death benefits.

With several variations, it may be that such property will pass to the named beneficiary, which forces the surviving spouse to make up the difference from other community assets. Wisconsin apples this to business property. Texas permits certain inter vivos gifts can be made of community property without the consent of the other spouse, and would exempt these from the item or equal division requirements. Nevada has applied the concept to certain transfer payable on death. This approach could be viewed either as a “modified” item theory, or a form of the aggregate theory.

Example: at the death of Ernest, there is $500,000 of community property. Included in this is a $50,000 bank account (a so-called “totten trust” account) payable to Ernest’s son. In true item theory states, such as California, Ernest’s wife Miranda is entitled to her one-half of each community asset, including the bank account. In modified item theory states, she cannot claim half of the insurance proceeds, but can take an addition $25,000 from Ernest’s share of other community assets.

Assuming the item theory is in place, it is still possible for the surviving spouse to agree to a non-pro-rata division of the property post mortem, and it also appears that the spouses could make a pre mortem agreement relating to the allocation of community property at death. California has specifically enacted a provision permitting such agreements. However, this could have tax consequences.

PROBATE ADMINISTRATION

Another area in which there is considerable variation in the law of the community property states is the necessity of probate administration of community property. For example, in California, if community property (or for that matter, separate property) passes to the surviving spouse, the transfer may be accomplished without the necessity of a formal probate. In any case the community property share of the surviving spouse is not subject to probate administration.

However, probate avoidance may come at a cost. At least in California, if probate is avoided, there is no way to adjudicate any creditor's claims against the estate of the deceased spouse. As a result, the surviving spouse takes the community property subject to creditors' claims, at least to the extent of the value of the property. A formal probate of all community property forces creditors to present their claims in court, or lose their rights.

Many of the other states which do require a formal probate have adopted the Uniform Probate Code, which considerably simplifies probate administration. Texas has a probate system which requires even less.

AL – WHAT HAVE YOU GOT ON THIS?

FORCED ELECTIONS

The concept of a forced share election is that a deceased spouse is attempting to dispose of property which is either owned by his or her spouse or to which the surviving spouse is entitled as a matter of law. While the concept can apply in a non community property state, it seems most common in community property jurisdictions.

Basically, the scenario for a forced election involves a will, or possibly a trust or other form of transfer, under which it is clear that the decedent is disposing of more than his or her share of community property, Of course, the decedent has no legal power to do this, and the surviving spouse can reject this, since it includes the survivor's property. However, the decedent forces the hand of the surviving spouse by making other provisions for the spouse in the will, trust, or other transfer, but stipulating that if the spouse elects to take the survivors full one-half interest in the community property the spouse will not receive other benefits, in other words, will be disinherited.

Example: The will of Wilbur provides that 100% of the community property will be transferred to a trust. Under the terms of the trust, the trustee, a third party, is to pay all of the trust income to Florence Wilbur's wife, for life, remainder equally to their three children. The trustee is also empowered to invade the principal of the trust if necessary for the support, health, and maintenance of Florence. However, if Florence elects to take her one-half o the community property outright, then the trust provides that she will receive no income or other benefits, and the balance of the trust will pass to the three children.
It is apparent from this example that Florence is forced to decide between taking the benefits of the trust, and giving up all control over her own property, or taking control over her property and giving up any other benefits. How she will decide

this issue depends on many factors, including her age and health, and her desire to see the children inherit.

While there is no public policy as such against the forced election, the courts have strictly construed it. First of all, it must be absolutely clear that the decedent is forcing the election. In other words, if the will in the above example simply said, I am leaving "the community property" in the trust, it is doubtful an election will be inferred, unless there is much more specific language forcing the spouse to a decision.

A forced election can arise outside of a will. In a California case, a life insurance policy on the life of the husband was clearly community property. Under the beneficiary designation, his wife was to receive a life annuity, with a residual annuity to their three daughters if the wife died within 10 years. On the death of the husband, his wife claimed one-half of the proceeds of the policy as her community property interest, and also sought to claim the annuity for life in the other half. The California Supreme Court held she was forced to an election, and if she claimed her half of the proceeds, could not also claim the annuity.

AL – HELP ON THIS?

QUASI-COMMUNITY PROPERTY

The concept of quasi-community property will affect the transfer of separate property at death. If quasi-community property acquired by the decedent is part of the decedent's estate, the surviving spouse is generally entitled to the same interest in it he or she would take in community property.

Example: George and Martha moved from New York to California. They owned several shares of corporate stock, all of which had been purchased with George's earnings in New York. Assume George is the first to die.. Under California law, the stock is designated quasi-community property, and Martha has the same rights in it she would have in community property. Now assume Martha is the first to die. Her estate has no interest in the stock, and it is entirely the separate property of George.

THE ALLOCATION OF DEBTS AND EXPENSES OF ADMINISTRATION

The proper method of allocating debts and expenses of administration at the death of a spouse varies greatly among the community property jurisdictions. In those jurisdictions which follow the concept of community debts and separate debts, the general practice will be to allocate those debts accordingly to the community and separate assets. There are variations, particularly in Washington. In California, where there are no community debts as such, the debts are allocated on the basis of which spouse incurred the obligation, and which property can be reached to pay it.

RECOGNITION OF THE COMMUNITY FOR TRANSFER TAX PURPOSES

Following the decision of the U.S. Supreme Court in Poe v. Seaborn, , 282 U.S. 101, the equal ownership of community property is recognized for federal gift, estate, and generation-skipping transfer tax purposes. In the case of lifetime gifts, each spouse can, subject to spousal consent and other rules, make a gift of his or her one-half interest in community assets. In the case of conversion of separate to community property, or visa versa, this requires a transmutation which is a taxable gift, but the gift tax marital deduction under IRC § 2523 is available. Thus where good estate planning indicates such a transmutation is indicated, it can be accomplished with no gift tax consequences

For federal estate tax purposes, only the decedent's one-half interest in community property is subject to tax. The generation-skipping transfer tax is imposed on either lifetime gifts or transfers at death, based on the value of the property transferred as determined either for gift or estate tax purposes. Community property rules also affect the valuation of property for gift and estate tax purposes, as well as the deductions for debts of a decedent and administration expenses of an estate.

Property owned by the decedent at the date of death is subject to federal estate tax under IRC § 2033. Ownership of property is determined under state law. Therefore, only the decedent's one-half interest in community property is included in his or her taxable estate.

If the IRS questions a determination that the property in question is community, the burden of proof has historically been on the estate to prove that it is. The shift of the burden of proof rules under the IRS Restructuring act will have a substantial impact on this.

All of the classification issues discussed herein will apply. Of particular importance will be agreements between the spouses which may have transmuted property from community to separate or visa versa. See ¶6.01. Also see Estate of Ridenour, TC Memo 1978-328 and Damner, 3 TC 638. Record title is not controlling, but does give rise to presumptions. Also see Estate of Burkitt, 3 BTA 1158 (1926).

It is important to remember that the determination of property rights is a state law matter. In general, the IRS has recognized this. In Rev Rul 54-89. 1954-1 CB 181, a Texas resident purchased real property in New Mexico and Kansas. He took title in his own name. On the death of the husband, the IRS determined that under New Mexico law, only one-half of the “community property” was included in his estate, and this was effective for estate tax purposes. As to the Kansas property, the IRS determined that even though Kansas is a separate property state, and the title was solely in the name of the decedent, Kansas law would impose a constructive trust on one-half of the value of the property in favor of the wife; therefore, only one-half of the value was included in the husband's taxable estate. A similar result will be found in Rev Rul 72-443, 1972-2 CB 531.

Estate and Gift Tax Aspects of Title

As discussed above, the record title in which property is generally not conclusive as to its community or separate nature. See Estate of Burkitt, 3 BTA 1158. However, to the extent the form of title creates presumptions as to its community or separate status, there is no reason the IRS cannot take advantage of these presumptions.

If a change in form of title results in a transmutation of community to separate property or vice versa, a gift results from one spouse to the other. However, in view of the unlimited marital deduction, this will not result in a taxable gift unless a third party has an interest in the property. If a joint tenancy is created from community property funds, this is treated as an equal contribution by both joint tenants, so that upon the death of either, only half of the value of the joint tenancy property is subject to federal estate tax under IRC §. 2040. Rev. Rul. 55-605, 1955-2 CB 283. Also see Rev. Rul. 78-418, 1978-2 CB 236, where the parties moved to a separate property state and purchased joint tenancy property with community funds. Note: There is now conclusive presumption that spouses have made equal contributions to joint tenancies; it no longer matters whether contributions are from separate or community sources. The same rules should apply to tenancies in common. However, despite IRS resistance, this may not apply to joint tenancies created before 1981. A husband had deeded property to himself and his wife a joint tenants prior to 1976. He died in 1989. Under both the 1976 and 1981 changes in IRC '2040, the property would only receive a 50% basis step up. In 1990, the surviving spouse sold the property. She then died, and her estate is claiming a full step up in basis equal to the fair market value at the death of her husband. Following the reasoning in Gallenstein v. U..S.,, 975 F2d 286 (6th Cir. 1992), the Fourth Circuit, in Patten v. U.S., 80 AFTR2d &97-5037, has held that even though the husband died after the 1981 amendments, the 1976 rule was still in effect at his death, meaning there was a full basis step up. A strong dissent argued that the 1981 amendments clearly applied to the estate of the husband, who died after that date, in which case there is only a 50% basis step up. Now the 5th circuit has reached the same result in Wheeler v. U.S. ,116 F3d 749 (5th Cir., 1997). The Tax Court decision following the Gasllenstein rule. See Hahn, 110 TC #1.

In Schnack Estate, 1986 TCM 570, the wife withdrew funds from a joint tenancy bank account to pay premiums on insurance on the life of her husband. The joint account was created with community funds. The court held that upon withdrawal from the account, the funds became the separate property of the wife!! The court held this was a "true" joint tenancy, and that since the funds could be withdrawn by either spouse, they would be withdrawn as separate property. In California, which was apparently the jurisdiction in this case (there is a reference to Nevada in the opinion as well) , this seems clearly incorrect under Cal. Prob. Code §. 5305, holding that funds in a joint bank account between husband and wife are presumed to be community property and that the account does not in any way alter their community property rights.

Assets Held in a Revocable Trust

A popular estate planning device in many community property states is the use of a revocable living trust to hold assets. Where this is done, substantial issues may arise as to whether or not the spouses have retained their community property rights, or have somehow "transmuted" property rights. The following are issues to consider:

1. Will the property retain its status as community property while in the trust? Upon withdrawal?
2. Under what circumstances, if any, will the creation of such a trust result in an Interspousal gift or transmutation of community property?
3. At the death of one spouse, what are the rights of the surviving spouse with reference to the trust and the trust assets?
4. Who can revoke the trust?

Where one spouse transfers community assets to a revocable trust without the joinder or consent of the other spouse, this would appear to be consistent with the management and control rights of the spouse. The other spouse, also consistent with his or her management rights, should be able to revoke the trust and remove assets from it. In this case, it seems clear the assets have not lost their community property character, and the spouses have not altered their community property rights.

The second possibility, which could create more problems, is where one spouse creates the revocable trust, and under its terms, retains complete control over it. If the other spouse consents to this arrangement, has he or she forfeited community property rights? In Katz v. U.S. 382 F2d 732 (1967), this issue was presented to a federal district court, which concluded that the consenting spouse had forfeited her community property rights, and that 100% of the property was includible in the taxable estate of the husband who created the trust. Fortunately, the 9th Circuit reversed this decision, correctly holding that the mere signing of a consent form did not constitute a waiver or transmutation of the community property rights of the consenting spouse. It should be noted that one argument the district court found persuasive was that the consenting spouse gave the managing spouse a general power of appointment over the trust assets.

The Internal Revenue Service has expressed its opinion on California community property law with respect to revocable trusts in Rev. Rul. 66-283, when it held that assets in a revocable trust constituted California community property where the following facts existed:

There was a reservation of income and the power to alter, amend, or revoke during the joint lives of husband and wife.

The trust provided that any property in it would remain community property, and any withdrawals of corpus from the trust would be community property.

After the death of one spouse, the other spouse could still revoke as to his or her one-half community property interest in the trust.

Also, in Rev. Rul. 76-100, 1976-1 CB 123, an installment note which was community property was transferred to a trust which either spouse could revoke as to his or her interest during his or her lifetime, but which became irrevocable as to only the deceased spouse's interest at death. The IRS ruled that the transfer of the note to the trust was not a disposition, which would indicate the transfer did not change its community status.

Although Rev Rul 66-283 was issued many years ago, it has established a standard for preparation of revocable trusts, and in fact was the basis of statutory rules to the same effect in California. Thus the right of revocation is usually granted to either spouse, but amendments require joint consent. The trust should specify that any community property transferred to it will retain its community status. If assets are withdrawn from the trust, it should stipulate they will be treated as community property.

Gift Tax Issues

A gift of community property by the spouses will be treated as a transfer by each spouse of his or her one-half interest in the property. Note that the election of spouses to split gifts under IRC § 2513 was adopted to permit transfers of separate property to achieve the same result. If there is any question as to whether or not the transferred property is community, it is wise to make the gift splitting election on the gift tax return, so that the gift tax result will be essentially the same whether the property is determined to be community or separate.

One difference between gift splitting of gifts of separate property and gifts of community property is that in the latter case, each spouse is treated as the donor of one-half of the property. Under a gift splitting election, the spouses are jointly and severally liable for any gift tax liability. If the gift is of community property, and no gift splitting election is made, each spouse is liable only for the tax on his or her one-half of the transfer.

Under IRC § 2035, there are circumstances under which gift transfers within three years of death may trigger estate tax issues. Where the subject of the gift is community property, these rules will only apply to the one-half interest of each spouse.

Example: Harrison and Emily own a life insurance policy on the life of Harrison. All of the premiums have been paid with community funds, and under the rules discussed in Sec , the policy is community property. They transfer the policy to an irrevocable life insurance trust, and Harrison dies within three years of the transfer. Under IRC § 2035 (a)(2), half of the proceeds will be included in Harrison's taxable estate.

Note that if both spouses die within three years of the transfer of the community property life insurance, the IRS may take the position that one-half of the proceeds will be included in the estate of each spouse. They have done that in Rev Rul 81-14, IRB 1981-2, 26, and LTR 8011080.

Example: William and Mary made a substantial gift of community property, and paid a gift tax of $200,000. Mary died within three years of the gift. Under IRC § 2035(b), any gift tax paid on transfers within three years of death is included in the transferor's taxable estate. Mary's estate would include one-half of the gift tax, $100,000.

Revocable Transfers

What if one spouse makes a gift of community property to a third person without the consent or joinder of the other spouse? The circumstances where such consent or joinder is required were discussed previously. Since the nonconsenting spouse can set aside the entire gift while both spouses are alive, it may be argued the gift is incomplete during the period it can be revoked. According to Reg § 25.2511-2(b), a transfer is not a completed gift unless the property is put "beyond the recall" of the transferor, i.e., he or she cannot get it back. If one spouse purports to make a gift without the consent of the other spouse, generally in writing, the other spouse can recall the entire gift. It therefore appears the transfer is incomplete for federal gift tax purposes, and also for federal estate tax purposes. However, since the general rule is that the donor spouse cannot revoke the gift, it is arguable that it is complete, at least as to the donor's one-half community interest. It also seems clear that the gift cannot be treated as a completed gift by the nonconsenting spouse, since he or she can revoke it. In those cases where one spouse can make a gift to a third person without the consent of another, the gift should be deemed complete as to the community property interests of both spouses.

If a gift tax return is filed, and the non-consenting spouse signs it, that should be sufficient written consent to the gift. However, an argument could be made that the gift is not complete as to that spouse's interest in the community property until the return is signed.

Example: Herman, without the knowledge or consent of his wife Susan, made a gift of X Corporation stock to their son, Sam. the stock was valued at $100,000. Herman died five years later, at which time Susan found out about the gift. At that time, the stock was worth $500,000. She did not seek to recover the property. It is not clear whether Herman made a gift of one-half of the value of the stock $50,000, at the date of the original transfer, or whether this is treated as a transfer of one-half of its value, $250,000, at death. In this case, it would be subject to estate tax under the rules discussed in Sec. In any case, the failure of Susan to set aside the transfer, at least as to her community one-half, would be treated as a taxable gift of stock valued at $250,000. See Reg § 25.2511-1(h)(9).

Irrevocable trusts – Retained Interests

Other than the issue of obtaining the necessary spousal consents, discussed in the next section, the creation of an irrevocable trust holding community property should not differ materially from a trust holding separate property. However, a trap to avoid in this situation is a trust in which one of the spouses has control or a beneficial interest.

Example: Husband created an irrevocable trust for children, naming his wife as trustee. The attorney used a standard trust form under which the trustee has control over the timing of trust distributions. Since the children are all adults, and the transferor husband had no retained controls, the attorney concluded there were no estate tax problems. However if the trust was funded with community property, the attorney and his malpractice carrier will find that since she is deemed to have transferred one-half of the property to the trust, half of the value will be included in her taxable estate under IRC § 2038.

Another trap to avoid is the creation of any life income interest or similar right in the spouse where there is an irrevocable transfer of community property. The result could be a transfer with a retained income interest under IRC § 21036. This can be a particular problem in life insurance, trusts, where the premiums are paid with community funds. Practitioners in community property states seek to avoid this by the creation of separate property through transmutation.

Example: Wife created an irrevocable life insurance trust funded with a $1 million policy on her life.. If her husband survives, he Thereafter, she entered into an agreement with her husband under which they partitioned community funds, each taking half of the total as separate property. This is memorialized in a written agreement. She will use her half, which is deposited in a separate bank account in her name, to pay the premiums.

Note: Can the husband use his half of the funds to pay premiums on a similar life insurance policy on his life held in an irrevocable trust? Beware the reciprocal trust doctrine!

Note: Where group term insurance is transferred to such a trust, it will be difficult to avoid community characterization if the premium are paid by an employer. Could all of this be accomplished more easily by a spousal agreement that the policy and proceeds are separate property of the insured spouse? Beware the step transaction doctrine.

An issue of estate inclusion has arisen in those states which follow the Texas rule that income from separate property is community property. Thus where a husband transferred community property into a trust in which it was clearly characterized as the wife's separate property, the IRS nevertheless included one-half of the value of the trust in the estate of the husband on the grounds that since the income from separate property is community property, he had made a transfer in which he retained one-half of the income under IRC § 2036. While this issue is not entirely free of doubt, the IRS appears to have conceded it, at least in Texas, in Rev Rul 81-221, 1981-2 CB 178. Note the problem is particularly acute in Texas, because the characterization of the income as community property is constitutional.

Life Insurance - In General

The proceeds of insurance on the life of a decedent are included in his or her estate if the insured possessed any"incidents of ownership", ad defined in IRC § 2042, or the insurance proceeds are payable to the insured's estate. This would include situations where the insurance proceeds are used to pay debts or administration expenses of the decedent. If the insurance is community property, only half of the proceeds are includible in the insured' estate, even if all of the proceeds are payable to or used for the benefit of the estate. Reg § 20.2042-1(b)(2). Where the premiums are paid with both separate and community funds, it may be necessary to allocate the policy proceeds between separate and community interests as discussed in Sec. also see Rev Rul 53-233, 1953-2 CB 268.

Generally speaking, where attempts have been made to transmute ownership of the policy to separate property of one spouse, clear evidence of the transmutation is required. In Freeman v. U.S., 382 F2d 742 (1967), the fact that the husband applied for insurance on the wife and was named the owner was not sufficient to make it separate property; the court assumed he was acting in his capacity as manager of community property. In Kern v. U.S., a typed provision in the policy on the husband indicating it was the separate property of the wife was not sufficient to overcome the presumption under Washington law that the policy was community property. See Sec for a discussion of the community presumption. the court in effect held the parties should have entered into a separate agreement to the effect the policy was separate property. A similar result was reached under Texas law in Rev Rul 67-278, 1967-2 CB 351.

As the above discussion indicates, merely naming one spouse or the other as the "owner" of the policy will not be sufficient to establish that it is community property. This is indicated by decisions in Meyer. 66 TC 41 (1976), aff'd without opinion 566 F2d 1182 (9th Cir., 1977)(Washington law); and Lutich v. U.S., 72-1 USTC § 12,852 (DC Cal., 1972). In McKee, 36 TCM 486, applying Texas law, the parties were able to overcome the community presumption by showing an intent to make a gift and transmute the policy to separate property. However, in Madsen, TC Memo 1979-289, testimony of the wife that there was an intent to make a gift and that she was the sole owner was not sufficient to overcome the community presumption under Washington law. The 9th circuit followed a U.S. Supreme Court determination that it was community property. Estate of Madsen v. Comm., 82-2 USTC § 13,495 (9th Cir., 1982).

In Estate of Wilmont, 29 TCM 1055, husband and wife each took out a policy on their own life, naming the other as owner-beneficiary. The court found sufficient evidence that there was an implied agreement to convert the funds used to pay the premiums from community to separate property. Note however, that when this case was decided, a transmutation could be by oral agreement in California, where this case arose.

Note that in the case of National Service Life Insurance, because of the federal preemption rules discussed in Sec, the policy and proceeds will be the separate property of the insured, even if the premiums are paid with community funds. Wissner v. Wisner, 338 U.S. 655 (1950). The proceeds will be includible in the estate of the insured spouse. Estate of Huston, 49 TC 495 (1968), Rev Rul 56-603, 1956-2 CB 601.

Life Insurance - Prior Death of the Non Insured Spouse

Assuming the spouse who is not insured is the first to die, and the policy is community property, it is well settled that his or her estate will include the value of the policy, which is generally equal to the interpolated terminable reserve plus prepaid premiums. If his or her interest passes to someone other than the surviving insured spouse, how are the proceeds taxed on the subsequent death of the insured spouse? This may depend on how premiums after death are paid.

Example: Wilma dies owning a one-half community property interest in a $1,000,000 life insurance policy on the life of her husband, Harold. Under Wilma's will, here community property interest in the policy passes to their two children. After her death, Harold continues to pay all of the premiums. On his subsequent death, the IRS attempts to include all of the proceeds less the amount included in Wilma's estate in Harold's estate.

In essentially the fact pattern described in this example, the 9th Circuit held that the amount included in Harold's estate would be a percentage of the proceeds, based on a ratio of all of the premiums paid by Harold (one-half attributable to community funds prior to death and all after death) to the total premiums paid. Scott v. Comm., 374 F2d 154 (9th Cir 1967).

If the interest of the non insured spouse in insurance passes to a trust controlled by the insured spouse, there is a substantial risk that the surviving spouse will have incidents of ownership as trustee and/or beneficiary, in which case the proceeds could sell end up in the taxable estate of the insured.

In the case of term insurance, there is an issue, as discussed in Sec, as to whether or not the non insured spouse has a community interest in the policy, at least prior to the death of the insured spouse. In Estate of Cavenaugh v. Comm., the Tax Court held that even though the non insured wife left her interest in community assets, including a renewable term policy on the life of her husband, to other beneficiaries, she really had no community interest in that policy since it had no cash value. The effect was to include the proceeds entirely in the estate of the surviving insured spouse. The 5th Circuit reversed the Tax Court, holding that the policy was community property, regardless of its value. The opinion cites the Scott case.

Annuities and Retirement Plans

When a participant in a qualified retirement plan or IRA dies, the first question will be whether or not his or her interest in the plan is community property. If it is, only one-half of the value should be includible in his or her estate. Where the nonparticipant spouse is the first to die, IRC § 2056(b)(7)(C) expressly provides that assuming his or her community interest in a qualified plan, IRA, or SEP passes to the participant spouse, it qualifies for the federal estate tax marital deduction if a QTIP election is made. Note a similar result in LTR 8943006, where the IRS concluded that the deceased nonparticipant spouse did have a community interest in the plan, but could not dispose of it. As a result, it passed to the surviving participant, and qualified for the marital deduction.

In the case of other death benefits, the usual community property rules should control. for example, in LTR 7807023, the husband had a salary continuation plan with his employer, with forfeiture provisions. His wife died. the IRS ruled that her community interest in the salary continuation plan, computed on an actuarial basis, would be includible in her taxable estate.

The community property rights in qualified retirement plans and IRAs is presently unclear, due in large part to the issue of federal pre emption of state community property laws. Assuming the benefit or IRA is community property, While there is some disagreement on the point, particularly with reference to Roth IRAs, many authorities believe it is not possible for a participant in a plan or IRA to make a gift of it. Some believe this can be done through an irrevocable beneficiary designation. If so, this would be a gift of one-half of the value of the account by each spouse. In any case, if the spouse of the participant has consented to the designation of a beneficiary other than the spouse by the participant, then on the prior death of the participant there would be a gift by the nonparticipant spouse of his or her community interest in the plan to the designated beneficiary. If the non participant spouse is the first to die, there should be no gift, but there will be estate tax issues.

The following is the guidance provided by IRS Publication 555 in this area:

Military retirement pay. State community property laws apply to military retirement pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the member of the Armed Forces was in active military service.

Pay earned while married and domiciled in a community property state is community income. This income is considered to be received half by the member of the Armed Forces and half by the spouse.

Civil service retirement. For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRS) or Federal Employee Retirement System (FERS).

Whether a civil service annuity is separate or community income depends on the mantel status and domicile of the employee when the services for which the annuity is paid were performed. Even if you are now living in a noncommunity property state and you receive a civil service annuity, it may be community income if it is based on services you performed while married and domiciled in a community property state.

If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status in community and noncommunity property states during his or her periods of service.

Example. Henry Wright retired last year from civil service after 30 years of service. He and his wife were domiciled in a community property state during the last 15 years of that service.

Since half the service was performed while the Wrights ware married and domiciled in a community property state, half the civil service retirement pay is considered to be community income. If Mr. Wright receives $1,000 a month in retirement pay, $500 is considered community income--half ($250) is his income and half ($250) is his wife's.

Lump-sum distributions If you receive a lump-sum distribution from a qualified retirement plan, you may be able to choose optional methods of figuring the tax on the distribution. You may be able to use the 5-year or 10-year tax option. You must disregard community property laws for either tax option.

Individual retirement arrangements (IRAs). When you and your spouse file separate returns, your contributions to an IRA must be based on your own compensation. Your contributions are limited to the lesser of your compensation or $2,000. When filing jointly, the contributions of the spouse with less compensation can be based on the combined compensation of both spouses, reduced by the amount allowed as an IRA deduction to the higher income spouse. Assuming your combined compensation for the year is at least $4,000, both you and your spouse can contribute up to $2,000 to an IRA, for a maximum contribution of $4,000.

Valuation Discounts

The value of lifetime gifts is discussed generally in Reg § 25.2511-1. It is the price a willing buyer would pay a willing seller for the property, neither being under an obligation to buy or sell. In the case of gifts of community property, this value would be based on a transfer by each spouse of an undivided one-half community interest in the property. In the case of marketable assets, this will generally be based on the market value of the asset. However, in the case of other assets, particularly real estate or closely held business interests, the value should be substantially reduced due to the fact a willing buyer would only be able to purchase an undivided one-half interest in the property. In Rev Rul 93-12, 1993-1 CB 202, the IRS abandoned attempts to aggregate family ownership for valuation purposes. Court decisions such as Estate of Bright v. U.S., 658 F2d 999 (5th Cir. 1981, Estate of Cervin v. Comm., 79 AFTR2d Para. 97,869, and Propstra v. U.S., 680 F2d 1248 (9th Cir., 1982). The Tax Court has followed this line of reasoning in Estate of Lee, 69 TC 860, allowing a discount in valuing stock to reflect the fact the estate of a deceased spouse only owned a 50% community interest in it.

The IRS has argued, with little success, that transfers of community property should be valued at 100% of the fair market value of the property, less the costs of partitioning it into two equal shares, divided by two. This was rejected in the Cervin case cited above.

Note that where title to property is held in joint tenancy, the Tax Court has held that it may lose its identify as community property, in which case valuation discounts would not be available.

Estate Administration Expenses and Casualty Losses

To the extent expenses are incurred to administer the estate of a deceased spouse, a determination will have to be made of whether any or all such expenses are chargeable to the community property of the surviving spouse. for example, California provides by statute that funeral expenses are to be allocated entirely to the decedent's share of community property. As a result, they are 100% deductible under IRC § 2053.

To the extent administration expenses are allocated to the surviving spouse's share of community property, he or she may be able to deduct them, at least in part, as expenses incurred for the protection and maintenance of income producing property under IRC § 212. Note that such a deduction will be subject to he 2% floor on miscellaneous itemized deductions under IRC §67(e).

Deductions for casualty losses under IRC § 2054 should follow the property subject to the loss, i.e., if there is a casualty loss resulting from damage to community property, and decedent's estate can only deduct one-half.

Debts of the Decedent

The proper allocation of debts and encumbrances to property is determined in accordance with state law. A decedent's estate can only discuss the share of such debts or encumbrances as are properly allocated to the estate under state law. U.S. v Stapf, 375 U.S. 118 (1963; Langs Estate v. Comm., 97 F2d 868 (1938). However, even if the debts are allocated to the decedent's property by a state court, the IRS is not bound by that allocation. Second National Bank of New Haven v. U.S., 387 U.S. 456 (1967).

Valuation Elections and Exclusions

Under IRC § 2032A(e)(1), if real property subject to valuation under its special provisions is community property the interest of the surviving spouse will be taken into consideration to bring the estate of the deceased spouse under the section. In other words, the percentage requirements will be determined as of 100% of the property is included in the estate of the first spouse. the total decrease in the value of the decedent's interest in the qualifying property under § 2032A is limited to $750,000(indexed for inflation). This applies only to the decedent's community interest in the property. Rev Rul 83-96,

IRC § 2o57 adopts a new estate tax deductions for qualifying interests in family businesses. Under IRC § 2033A(l)(3)(l), the rule of IRC § 2032A applies here. This means the community interest of the surviving spouse will be deemed part of the decedent's estate for purposes of determining qualification for the exclusion. It is assumed that the limit on the exclusion will, following the lead to § 2032A, be based only on the decedent's one-half community interest.

What is not clear under either of the above provisions is the extent to which community property interests are to be disregarded. It appears that in the case of IRC § 2032A, this means that 100% of the qualifying real property and personal property used to determine the threshold requirements is included. Similar under IRC § 2057, it appears that 100% of the qualifying business interests is included. What is not clear is the extent to which community gifts of business interests and other transfers are to be included.

Installment Payment of Federal Estate Tax

IRC § 6166 permits deferred payment of federal estate tax attributable to the decedent's interest in one or more closely held businesses if certain percentage requirements are met. The community interest of the surviving spouse is included in determining whether or not the decedent owned at least a 20% interest in each of two or more businesses, in which case they may be aggregated to meet the percentage requirement sunder the section. Further, a husband and wife are treated as a single shareholder or partner as to community property interests under IRC § 6166(b)(2)(b).

INCOME TAX ISSUES OF INTEREST TO ESTATE PLANNERS

How the IRS defines community property

While property rights are a matter of state law, federal taxation of income is a matter of federal law. Burnet v. Harmil, 287 U.S. 103. If under the law of the state of domicile the income is community property, each spouse must report half of it. Poe v. Seaborn, 282 U.S. 101, U.S. v. Mitchel, 403 U.S. 190. If one spouse reports all of the community income, half of it is still taxable to the other spouse, and negligence penalties may be imposed on the nonreporting spouse Cline, TCM 1982-302.

An exception to the domicile rule may occur if real property is involved, and the law of the state where it is located controls. For example, if a husband and wife acquire real property while living in a community property state, and move to a separate property state, the property and its income will still be community. Black v. Comm., 114 F2d 335, Johnson v. Comm., 105 F2d 454.

If the IRS reaches a conclusion on the community status of property or income, and the practitioner believes that is incorrect, how can the IRS determination be challenged? In Estate of Bosch v. U.S., 37 U.S. 456, the Supreme Court held that the IRS is only bound by the decisions of the highest court of the state on such issues. In other words, the IRS can independently interpret state community property law unless there is a Supreme Court opinion clearly in conflict, or of course, if there is a state statute specifically on the point.

It should be noted that the community presumption is acknowledged by the IRS.

TAX CONSEQUENCES OF INTERSPOUSAL AGREEMENTS.

Agreements of the spouses as to the status of their property and designation of income as separate or community will generally be recognized for federal income tax purposes. Van Dyke, 120 F . 2d 945 (1971). This has been applied to executed and unexecuted oral agreements, if their existence can be proved. For a decision in which the court accepted wife's testimony that a written agreement had been made, but was lost or destroyed, see Eimim, TC Memo 1984-130 since the agreement provided all income earned by husband during marriage was his separate property, the wife was not liable for tax on half.

If the spouses agree that any income earned after. the date of the agreement from personal services is to be separate property, this will be recognized for federal income tax purposes. Rev. Rul. 73-390, 1973-2 CB 12. It seems clear that this will not extend to income already earned under the general rules relating to assignment of income.

An agreement purporting to convert the income from separate property into community property was held to be ineffective in Rev Rul. 77-359, 1977-2 CB 24, decided under Washington law. This seems correct, since, as the ruling indicates, an attempt to convert the income from separate to community without conversion of the property that produces the income is an assignment of income.

Note the following language in the latest edition of IRS Publication 555:

The laws of the state in which you are domiciled govern whether you have community property and community income.

Community property. Community property is all property acquired by a husband or wife, or both, during their marriage while they are domiciled in a community property state. Certain property acquired by gift or inheritance, by purchase with separate funds, or by exchange of separate property for other property is not community property. (See Separate Properly and Separate Income, later). Community property also includes property that spouses have agreed to convert from separate property to community property.

According to state law, each spouse owns half the community property. Community property belongs as much to one spouse as it does to the other.

If property cannot be identified as separate property, it will be considered community property. For federal tax purposes, the property is classified according to the laws of the state in which you are domiciled.

Community Income. Generally, community income is all income from community property. It includes salaries, wages, and other pay for the services of either or both a husband and wife during their marriage.

In Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is treated as community income. You must identify community income in accordance with state law.

Income from real estate is community income if it is so treated under the laws of the state in which the real estate is located.

The classification of income as either community or separate is important if you and your spouse tile separate federal tax returns. If you do, half the community income must be reported by you and the other half by your spouse.

Several important points are made in the foregoing statements. In addition to acknowledging the community presumption, the IRS is acknowledging spousal agreements which transmute property and income. See the related dissuasion in ¶16.15. The IRS also strictly follows state law in the classification of income from separate property. In connection with gain or loss from property, the same follows. Refer to the following language in Publication 555:

Gains and losses. Gains and losses are classified as separate or community depending on the character of the property. For example, a loss on separate property, such as stock held separately, is a separate loss. On the other hand, a loss on community property, such as a casualty loss to your home held as community property, is a community loss.

The laws of the state in which you are domiciled govern whether you have separate property and separate income.

Separate property. Generally, separate property is all the property owned separately by you or your spouse before your marriage, as well as money earned while domiciled in a noncommunity property state. It is also property acquired separately after marriage by you or your spouse as a gift or inheritance. Separate property can be acquired during marriage by buying property with separate funds or by exchanging separate property for other property.

Separate Income. Generally, under the community property system, income from separate property is income of the spouse who owns the property. However, in Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is community income.

State law must be considered before federal tax laws are applied. If a husband and wife choose to file separate returns, the laws of the community property state where they are domiciled govern whether they have separate or community income.

Income from property acquired with both separate and community funds. Generally, if you acquire property during your marriage partly with community funds and partly with separate funds, the property is part community property and part separate property. Income from the part of the property bought with community funds is community income. Income from the part bought with separate funds is community income or separate income, depending on the laws of the state in which you are domiciled.

Will the IRS recognize income splitting under the Alaska system?

If the spouses elect to treat property as community under the elective system in Alaska, will the IRS recognize this for income tax purposes? In Comm. v Harmon, 323 US 46, the U.S. Supreme Court recognized that community property may arise either from a consensual arrangement such as that in Alaska, or by virtue of underlying state law, as in the nine community and marital property states. It held that the shift of income was not recognized for federal income tax purposes under its decision in Lucas V. Earl, 281 US 111 (1930). However, the Supreme Court did not decide that the property in question could not be converted to community property under a consensual arrangement.

If the rationale of the Lucas decision is controlling, it suggests that if federal law recognizes the conversion of property to community under state law, then any income subsequently earned from the property will take the same character as the property itself. In other words, so long as the "tree" is converted to community property, the "fruit" will thereafter also be community property.

It may be the IRS would permit the conversion of separate to community property by Alaska residents, but argue it cannot be done by nonresidents through the creation of an Alaska trust. Insofar as the authors can determine, there is no authority to the efface that nonresidents of community property states may create community property which has its situs in a community property states. The conflict of law and jurisdictional issues which may arise are beyond the scope of this presentation.

When Community Property Laws will be disregarded for federal income tax purposes.

There are a variety of circumstances where the Internal Revenue Code seeks to ignore commuity property laws for income tax purposes. Most of these relate to definitions of earned income, and limitations on medical and retirement benefits for employees and self employed individuals. for example, community property rules are disregarded for various purposes under the following provisions of the Internal Revenue Code:

1. The computation of earned income under IRC § 32
2. Limits on retirement savings plans under IRC § 219.
3. Limits on medical savings account deductions under IRC § 220
4. Almost all rules relating to qualified retirement plans, IRAs, and similar benefits under IRC §§ 402, 403, and 408. .
5. Deferred compensation plans under IRC § 457.
6. Educational IRAs under IRC § 530.

Disregarding community property rules where inequitable.

One exception to this general rule is found in IRC § 414. This is the provision for a qualified domestic relations order on divorce which allocates retirement benefits to the former spouse of a plan participant. In this case, orders based on community property rights are effective.

Community property rules are also disregarded in determining limits on the use of the cash method of accounting under IRC § 448.

In the Supreme Court decision in U.S. v. Mitchel, 403 U.S. 190, a spouse was subject to federal income tax on unreported income which was received by her separated spouse, and about which she had no direct knowledge. This led to Congressional relief for so called innocent spouses.

IRC § 66(a) provides that in the case of married individuals, either or both of whom has community earned income who:

live separate and apart at all times during the calendar year,

do not file a joint return, and

do not transfer community earned income to each other during the year,

the community earned income will be taxed entirely to the spouse who earned it. Further, IRC § 66(b) allows the Secretary of the Treasury to disregard the benefits of any communit prperty law to any taxpayer if he or she acted as if he or she was soley entited to the income and failed to notify the other spouse before the due date for the income tax return for the yearin question as to the nature and amount of the income.

IRC § 66(c) goes further. If a joint return is not filed, a spouse does not report a community interest in income earned by the other spouse and establishes he or she was not aware of it, and it would be inequitable to tax the spouse on a community interest in that income, it will not be taxed to that spouse. This is a specific application of the so-called "innocent spouse" rule to community income

Post Mortem Allocation of Community Assets – Entity or Aggregate?

An area of controversy in community property states is the possible income tax consequences if any, of a non pro rata allocation of community assets between the estate of a deceased spouse and a surviving spouse.

As already discussed, the "item" theory of community property is generally applied at the death of a spouse. Under this theory, the estate and surviving spouse are deemed to own each and every community asset as tenants in common. Some states, like Texas and Nevada, may not apply it to nonprobate transfers, such as life insurance payable to named beneficiaires. By case law, Arizona applies an "aggregate" theory, under which the first spouse to die can make a testamentary disposition of community assets not in excess of 505 of the total value of the community.

If under state law the estate and surviving spouse are each treated as owning an undivided one-half interest in each community asset, and after death, they agree to a non pro rata division under which each takes one half of the aggregate value of the entire community, is this a taxable sale or exchange for federal income tax purposes?

If the beneficiaries agree among themselves to take specific assets of equal value rather than dividing up each and every asset, the IRS holds that this results in a taxable sale or exchange between them. Rev Rul 69-486, 1969-2 CB 159. The Revenue Ruling indicates that if the non-pro rata distribution is within the discretion or authority of the trustee or executor, there will be no taxable event.

Based on the foregoing discussion of non-pro rata distributions of assets, it would appear that where community assets are involved, the estate and surviving spouse would each have to take an undivided one-half interest in each community asset to avoid taxable exchange problems. However, in LTR 8016050, the IRS ruled that where the surviving husband and estate of the deceased spouse divided up the community assets based on total value, there was no change in holding periods; therefore, by implication, no taxable exchange. The basis of the ruling was that each spouse (and their estates) owned an undivided one-half interest in the total assets, not each asset individually. If this ruling is correct, it would be possible to plan distributions in such a way that non-appreciating community assets would be allocated to the surviving spouse, and appreciating community assets of equal value allocated to other beneficiaries. It should be noted that in the ruling, the IRS cites authority based on the division of community assets at divorce. In California, the probable situs of this ruling, assets can be divided on a non pro rata basis by a divorce court, but this rule does not apply at death. Therefore, the legal basis of the ruling is doubtful.

A similar result was reached in LTR 9422052, where the IRS held a non-pro rata division of community property between a survivor's trust, marital trust, and bypass trust was not a taxable exchange. It held it was similar to a partition of trust assets, and the trustee had authority to make non-pro rata allocations. Both spouses executed the trust agreement. However, the ruling cites Rev Rul 69-486, 1969-2 CB 159, discussed above, and seems to assume surviving spouse is a beneficiary. In fact, the surviving spouse is a coowner of the property.
If these rulings, which are not authority, do not hold up, such a non-pro rata allocation of assets may have little or no income tax consequence when made shortly after death, since the community assets all obtained a new income tax basis at death. Therefore, little or no gain or loss may be realized. This would not apply to IRD items, which have no basis.

Post Mortem Allocation of Community Assets – Assignment of Income Problems

Aside from the possible sale or exchange consequences of a non pro rata post mortem allocation of community assets, consideration must also be given to the possible assignment of income issues. Based on the classic doctrine of Lucas v. Earl, 281 US 111(1930), the U.S. Supreme Court has ruled that community income is taxed equally to the spouses, regardless of who earned it. U.S. v Mitchell, 403 US 190 (1971). In the case of a divorce prior to the adoption of IRC § 1041, the 9th circuit held that where California accounts receivable were assigned to the husband (an attorney) on divorce, they were still taxed one-half to the ex spouse when collected. Johnson v. U.S., 135 F2d 125 (9th Cir., 1943).

The issue will arise in all cases where the community assets include any item of income is respect of a decedent which was earned as community property. It will be particularly significant in the case of employee benefits and IRAs. Prior to 1984, the IRS issued several private rulings on the tax consequences of allocation of community property retirement benefits on divorce. In general those rulings held that if there was a 50-50 split of the benefits, there were no tax consequences. LTRs 8001402, 8007-24, 8309144, 8204056. However, the IRS rejected an allocation of 100% of Keough plan benefits earned by one spouse to the other spouse in LTR 7952045.

It can be argued that none of the above cases or rulings are authoritative in this area, since the issue is the allocation of income in respect of a decedent. Under IRC § 691(a)(1)(B), if a right to receive income earned by a decedent is acquired by reason of death, the recipient, in this case the surviving spouse, will be taxed on it. Even if the right is deemed acquired by the decedent's "estate", Reg § 1.691(a)-4(a), the estate may transfer the right and the transferee will be taxed on it. However, if the transferor receives any consideration for the transfer, the transferor must include the value of the consideration in income. This brings us back to the issues discussed in the preceding section, i.e., is the non pro rata allocation treated as a sale or exchange?

Non-assignability of qualified plans

Another factor to consider in connection wit the allocation of community property IRAs or qualified plan benefits is that such benefits are generally subject to non assignment rules. While the IRS will generally recognize community interests in such plans, this This could certainly prevent the assignment of the plan benefits in a non pro rata allocation.

Income tax basis of assets at death

IRC § 1014(b)(6) provides:

(b) Property acquired from the decedent

For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

Reg § 1.1014-1(b) provides::

Scope and application.

With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of section 1.1014-2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and sections 1.1014-2 through 1.1014-8 are applicable, except as provided in section 1.1014-9. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of section 1.1014-2. These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and sections 1.1014-2 to 1.1014-6, inclusive, whenever the words "property acquired from a decedent" are used, they shall also mean "property passed from a decedent", and the phrase "person who acquired it from the decedent" shall include the "person to whom it passed from the decedent."

The application of the basis adjustment at death to both halves of community property is one of the most important advantages of avoiding transmutation of community property to other forms. As discussed above in connection with revocable trusts, care must be taken to avoiding doing that inadvertently.

The issue of basis adjustment at death is a principal issue under the Alaska elective community property system. As already discussed, in the Harmon decision, the US Supreme Court appears to recognize that separate property can be converted to community property by agreement. If so, the basis adjustment rule of IRC § 1014(b)(6) should apply. Note that it is generally possible in community property states to "transmute" separate to community property, and the IRS has never argued that this is ineffective. See Rev Rul 77-359, Also note the decision in McCollum v US, 58-2 USTC ¶9957, where community property in Oklahoma received a double basis adjustment. Under the Oklahoma elective system. However, this case does not constitute reliable authority. At the time the community property was created, it was a consensual arrangement as in Harmon. However, by the time of the death of the first spouse, the system was mandatory.. However, as indicated above, the IRS may argue that the community system cannot be applied to nonresidents.

A major area of difficulty in this connection is joint ownership with right of survivorship. The principal issue in the determination of income tax basis involves situations where the property is held in a joint form of ownership between a husband and wife. If the effect of the joint tenancy is to terminate the community form of ownership, then IRC § 2040 will apply. Under its provisions, one-half of the joint tenancy property is included in the taxable estate of the deceased spouse, and only that half will obtain a new income tax basis. Thus the status of community property – joint tenancies is critically important. The presumptions which arise from joint tenancy and other forms of joint title between a husband and wife are discussed in ¶¶555-575.

The Tax Court, in a reviewed opinion, has held that upon the death of the husband in California, property held in joint tenancy with his wife was joint tenancy, not community property, despite a determination by a local probate court that it was community property. The court refused to give effect to the state court determination, finding that the parties did not intend the property to be community property, nor had they effectively transmuted it from joint tenancy to community property.

The facts indicate that the spouses acquired five parcels of real property, one before and four after January 1, 1985. In each case, they took title as joint tenants with right of survivorship. When an estate tax return was filed (late), the preparer excluded half of the property from the estate of the husband on the grounds it was community property, and also claimed a 15% valuation discount under the authority of Propstra v. U.S., 680 F2d 1248 (9th Cir. 1982). The parties also filed a spousal property petition in Superior Court (Los Angeles) and that probate court determined the property was community, and set it aside to the surviving spouse.

The Tax Court started with the proposition that under California law, joint tenancy and community property are mutually exclusive forms of property ownership. While there is a strong presumption that property acquired during marriage is community property, there is a rebuttable presumption that the character of the property is as set forth in the deed. The Tax Court noted that no evidence of either an oral or written transmutation was submitted in the probate court hearing

It also found that the testimony of the surviving spouse that in some cases a real estate broker recommended the joint tenancy to avoid probate, that she thought it belonged to both of them, and that she owned one-half of it was not persuasive. Noting that the surviving spouse did not speak, write, or understand English, the court found there was no mutual agreement between the parties that the property was community.

As to transmutation, the Tax Court notes that an oral transmutation would have been effective as to the one property acquired before 1985, but a written transmutation is required for the four properties acquired after January 1, 1985. The court found no evidence of oral or written transmutation, and that a declaration in the decedent's will which refereed to "community property," but not joint tenancy was not an "express declaration" which is required for an effective transmutation. Bottom line - it is joint tenancy, not community property.

On the discount issue, the court rejected an argument that the discount should apply to undivided interests in joint tenancy, concluding that the "willing seller-willing buyer" test does not apply to joint tenancies, because of the specific inclusion provisions of IRC §2040, which start with full inclusion of the property in the estate, then allow a reduction for the consideration furnished by the surviving joint tenant, which in the case of spouses is 50% under IRC §2040(b). The court found that the basis for the discount in Proposta was that under IRC §2033, only 50% of the value of the property is included in the estate to begin with. Estate of Wayne-Chi Young, 110 TC #24 (1998).

Is this a dramatic change of position by the IRS on the status of joint tenancy titles in community property states? No, despite conventional wisdom, the IRS and the courts never held property titled in joint tenancy between husband and wife can be treated as community property for federal tax purposes. The basis of the conventional wisdom is probably the Ninth Circuit opinion in United States v. Pierotti, 154 F.2d 758 (9th Cir. 1946). Property was held in a joint tenancy title. When the husband died, the joint tenancy was terminated in favor of the wife. The court determined that the property had been acquired with community funds, and citing California authority, decided that under California case law, it would probably be treated as community property for California purposes, since the parties had an oral agreement or understanding that it was community property. Note the court gave no weight to the fact the surviving spouse had filed a petition to establish the fact of death of the predeceased spouse, which was of course a necessary step at that time in claiming title to the property as surviving joint tenant.

Compare Bordenave v. U. S., 150 F. Supp. 820 (D.C.N.D. Cal. 1957). The husband had acquired property in his name alone with community funds, and unilaterally conveyed it into joint tenancy form. His wife signed the deed. Upon the death of the first spouse, the surviving spouse filed a petition to establish the fact of death, and accordingly took title as surviving joint tenant. As was required in such affidavits, she swore that the property was joint tenancy. She subsequently testified that both spouses considered it to be community property. The federal district court held it was not community property, and to a large extent based this determination on the fact that the surviving spouse under penalty of perjury declared it was joint tenancy. On this basis, the court held that since under California law joint tenancy is treated as one-half he separate property of each spouse, it had been transmuted from community.

The really definitive IRS position on this issue is found in Revenue Ruling 87-98, 1987-2 C.B. 206,. Husband and wife, who lived in an unspecified community property state, purchased property in that state with community funds and took title as joint tenants with right of survivorship. However, they later executed joint wills in which they declared the property was community. The question was whether or not it would be recognized as community property for federal income tax purposes. The IRS first notes that the state in question, while permitting title to be held in joint tenancy by husband and wife, made no provision for "the coexistence of a common law estate and a community property interest,..." As a result, taking title in a common law estate raised a presumption that the spouses had terminated their community interest, "effectively transmuting the property's character from community to separate."

The ruling cites Revenue Ruling 68-80, 1968-1 C.B. 348, which held that where property was acquired by a husband and wife as tenants in common in exchange for community assets, it constituted separate property under state law. Note the following important language in the ruling: "However, the controlling factor was the state law determination that the property did not constitute community property."

All the ruling really says is that if the joint tenancy property would be treated as community property under state law, the federal government will follow that result, and not attempt to apply a separate federal test to determine its status as community property. The ruling goes on to apply state law to find that the declarations in the joint wills prevented the transmutation of the property from community to separate. It concludes: "If property held in a common law estate is community property under state law, it is community property for purposes of § 1014(b)(6) of the Code, regardless of the form in which title is taken."

Assuming this is still the IRS position, the decision in this case may well be unique to California, which appears to be the only community property state which has not taken at least some action to eliminate the problem. Nevada and Wisconsin (following the Uniform Marital Property Act) solved it by creating a new form of title "community property with right of survivorship." Idaho, Texas and Washington have various provisions permitting spouses to agree to a right of survivorship in community property. New Mexico has determined that an inter spousal joint tenancy with right of survivorship is really community property with right of survivorship. Arizona dies not permit spouses to take title as joint tents unless they specify in the deed or a related document that the property will not be classified as community. Louisiana, being a civil law jurisdiction, really does not have the problem.

While the issue in this case was the available valuation discount, the following issues are probably more important:

1. Under IRC §1014(b)(6), both the decedent's and survivor's share of community property receives a basis adjustment to fair market at date of death or estate tax value, if different. Only the decedent's half receives a new basis in the case of joint tenancy, assuming only half is included in the decedent's gross estate under the general rules of IRC §1014. I the case of appreciating California property, this is disastrous.

2. In this case, the property was all included in the estate of the surviving spouse either way. In many cases, the community property interest of the deceased spouse would not pass to the surviving spouse, but instead passes to marital deduction and bypass trusts. If the property is joint tenancy, it passes to the surviving spouse by operation of law, and if it somehow ends up in trusts created by the deceased spouse, there will be gift tax consequences. Further, there will still be estate tax consequences when the surviving spouse dies, to the extent the survivor is deemed to be the transferor, and under the terms of the trust or

trusts, is entitled to the trust income (IRC §2036(a)) or has control over the trust or trusts to the extent subject to IRC §§2036 or 2038.

3. To the extent a marital deduction trust is funded with property which would pass to the surviving spouse by right of survivorship, there may be an impact. Hopefully, this will not jeopardize the status of a marital deduction trust, although we have no authority on what happens when property belonging to a surviving spouse is added to a QTIP trust.

4. Watch out for non-citizen spouses, as the qualification for the estate tax marital deduction is radically different when property passes outright to a surviving spouse, as in the case of joint tenancy, or is committed to a qualified domestic (QDOT) trust. Note that a logical solution to the issues raised in points (2) through (4) above is a qualified disclaimer