Community Property—The Rules and Their Impact on Income Tax and Estate Tax Return Reporting

By David L. Rice, Lavar Taylor and William S. Ryden

David L. Rice, A. Lavar Taylor and William S. Ryden examine California Community Property Laws and the unique way community property ownership affects income and estate tax reporting and IRS collection efforts.

DAVID L. RICE, J.D., LL.M., is a Certified Tax Specialist with the State Bar of California and Elder Law Specialist with the National Academy of Elder Law Attorneys. His firm, David Lee Rice, A Professional Law Corporation, is located in Torrance, California.

A. LAVAR TAYLOR is the Founder of Law Offices of A. Lavar Taylor, APC, in Santa Ana, California.

WILLIAM S. RYDEN, J.D., is a Certified Family Law Specialist and a member of the American Academy of Matrimonial Lawyers. Mr. Ryden is a Partner with Jaffe and Clemens located in Beverly Hills, California.

Background

It is important for every tax practitioner to understand State Property laws to properly advise clients on tax planning, estate planning and tax controversy matters. Federal tax law has always deferred to State laws to determine the character and nature of property.[1] As an example, can the IRS levy on a husband and wife's bank account held in joint tenancy for the wife's tax liability? If an estate planning lawyer prepares a deed adding a wife's name to real property, is that a proper transmutation? This article will focus on California Community Property Laws, but it should be noted that a total of nine States are community property states.[2]

California law defines community property as any asset acquired or income earned by a person while married or in a domestic partnership that is not a gift or inheritance.[3] There is a presumption in California that property acquired during marriage is community property.[4] Separate property is defined as anything acquired by a spouse before the marriage; during the marriage by gift, devise or bequest, and after the parties separate.[5]

As discussed above, property acquired by the parties during marriage that is in joint form[6] (*e.g.,* tenancy in common, joint tenancy, community property or community property with right of survivorship) is presumed to be community property for purposes of dissolution of marriage or legal separation of the parties.[7] This presumption is rebuttable under Fam. Code § 2581. This legislative intention was set for in Fam. Code § 2581. Under that section, where parties are

determining how to divide property upon dissolution of marriage or upon legal separation, they may divide such property according to either (a) a clear statement in a deed or other documentary evidence of title by which property is acquired that such property is held in a manner other than community property (*i.e.,* separate property), or (b) some other evidentiary proof that the parties have made a written agreement that the property is to be treated as separate property.

Community Property Transmutations

Statutory Law

Every tax practitioner must not only understand the basic tenets of California Community Property law but also gain an understanding as to when property may be transmuted from one form of ownership to another. If a domestic partner adds a partner as a joint tenant to a deed, was there a valid transmutation? If a husband and wife purchase property with community funds but take title as Joint Tenants, is the property community or separate under California law?

It is important for every tax practitioner to understand State Property laws to properly advise clients on tax planning, estate planning and tax controversy matters.

California Family Code § 850 provides that married persons may, by agreement with or without consideration, do any of the following: (a) transmute community property to separate property of either spouse; (b) transmute separate property of either spouse to community property; and (c) transmute separate property of one spouse to separate property of the other spouse. However, each of the transmutation sections is subject to fraudulent transfers.[8]

Family Code § 852 specifically focuses on the requirement that a transmutation of real or personal property be made "in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected." Furthermore, a transmutation of real property is not effective as applied to third parties without notice given, unless such real property has been recorded. However, certain gifts exchanged between the spouses of, such as clothing, jewelry or other tangible personal items that is solely or principally for the receiving spouse and that is not substantial in value (when considering the circumstances of the marriage) would not apply under this section.

California Family Code § 853 further clarifies circumstances where evidence leans in favor of or against a finding of transmutation. A statement made in a will cannot be used as evidence of a transmutation if the proceedings started prior to the death of the person who made the will. A waiver of any joint survivor or annuity benefits under ERISA is not a transmutation. A written consent or joinder of a nonprobate transfer is a valid transmutation if it comports with the provisions of Family Law Code § 582.

Case Law

One of the more interesting issues which has led to different conclusions is whether a couple can convert community funds to separate funds merely by using community funds to purchase property and then taking title in that property as joint tenants. The Ninth Circuit had to analyze this issue in the case of *In re Ann Marie Summers*.[9] In that case, the spouses made a down payment of $10,000 on the purchase of real property and the deed was recorded with their names along with their daughters as joint tenants. The trustee contended that the entire property was community property and was includible in the bankruptcy estate. The Bankruptcy Code provides that the estate of the debtor includes all interest of the debtor and the debtor's spouse in community property as of the commencement of the case.[10] The Court held that the source of funds for acquisition of the joint tenancy is not dispositive. The presumption that title reflects the parties' intent cannot be overcome simply by evidence of the source of the funds used to purchase the property.

The trustee further asserted that a transmutation had not occurred as the rebuttable presumption that property acquired during marriage is community property should apply. The Court then reviewed case law in this area and cited *In re Pavich,*[11] for the proposition that in California, the community property presumption is "overcome when a declaration in a deed or other title instrument indicates spouses take title to property as joint tenants." The Court, however, held that acquisitions of property are not necessarily transmutations. In other words, when spouses acquire property, they can specify how title will be held. Thereafter, any change must meet the requirements of a transmutation. Real property transfers between spouses should be executed following all the usual rules and formalities of transfers of real property between any other persons or entities. Spouses can show their agreement to take the property as joint tenants by explicitly taking title as such.

Similarly, the Court determined in *In Re. John T. Gorman*[12] that although property acquired after marriage is presumed to be community property, property purchased with community funds, standing alone, is insufficient to rebut the presumption created by the form of the deed. The lower court's decision there was reversed and the Supreme Court of Nevada held the property in question to be in the form of joint tenancy.

The California Supreme Court of *In re Marriage of Valli*[13] was decided shortly after Summers determined that the rationale in Summers was not persuasive authority with respect to transmutation and property characterization issues. In *Valli,* the husband during the marriage used community property funds to purchase a $3.75 million life insurance policy on his life, naming his wife as the policy's only owner and beneficiary. At the time of dissolution, the wife contended it was her separate property and the husband contended that it was community property. The Supreme Court of California concluded in a unanimous opinion that in a marital dissolution proceeding, unless the statutory transmutation requirements have been met, acquisitions of property made by one or both spouses from a third party during marriage are not exempt from the marital property transmutation statutes governing transmutation of community property to separate property.

Following the decision in *Valli*, the Bankruptcy Court in the case of *In re Obedian*[14] held that under California law, property acquired by debtor and her nondebtor spouse during their marriage with community property funds was community property and that the trustee failed to show by a preponderance of the evidence that debtor and nondebtor spouse transmuted the character of property from community property to separate property.

In *In re Obedian*, Wife, a Chapter 7 debtor, filed a motion in Bankruptcy court to avoid a judgment lien against the nondebtor Husband. The bankruptcy trustee and the IRS opposed the motion. The Husband and Wife were married in 1972. During their marriage, Wife and Husband purchased a parcel of real property in Tarzana, California with community property funds and subsequently made the mortgage payments on the house with community income. After selling the property, in 2009 during their marriage, Wife and Husband used the proceeds from the sale of the Tarzana house as a down payment to buy another real property in Beverly Hills. They took record title as joint tenants. The grant deed transferring the property to Husband and Wife stated that they were taking title as joint tenants, but there was no separate statement on the grant deed indicating that this was their express intention. They paid the mortgage on the Beverly Hills property with their community property income.

After Wife and Husband bought the Beverly Hills property in 2009, a judgment was entered against Husband in the amount of $729,890.29. The judgment creditor recorded an abstract of judgment on February 22, 2011, to perfect its judgment lien against the Beverly Hills property. Wife, a Chapter 7 bankruptcy debtor, filed a motion to avoid the judgment lien against her nondebtor spouse. The bankruptcy trustee and the IRS opposed the motion.

If debtor Wife's interest in the Beverly Hills was community property, the judgment lien against nondebtor Husband would attach to both spouses' interests in the Real Property Fam. Code §910. But if Wife's interest was separate property, as indicated by record title in joint tenancy, then the judgment lien against Husband would only attach to Husband's one-half joint tenancy interest, which would not be an asset of Debtor's bankruptcy estate.

Based on *Family Code* § 760, the court preliminarily determined that the real property should be presumed to be community property since Debtor Wife and nondebtor Husband acquired the property during their marriage with community property funds and no evidence was presented that would rebut the community property presumption through tracing or earnings or accumulations while Wife and Husband were living separate and apart.

Wife argued that she and Husband never validly transmuted the property because there was no express declaration in writing that changed the character of both the community property sale proceeds from the sale of the Tarzana house and the community property mortgage payments on the Beverly Hills property to separate property. Thus, Wife argued that under the California marital property transmutation statute, the Beverly hills property was community property.

The trustee argued that because the grant deed conveyed the Real Property to Wife and Husband as joint tenants, they owned the Real Property as joint tenants with each having a one-half separate property interest.

However, the bankruptcy court noted the undisputed fact that Wife and Husband took record title to the Beverly Hills property as joint tenants and found Wife's argument to be in conflict with *California Evidence Code* § 662, which provides that "[t]he owner of the legal title to property is presumed to be the owner of the full beneficial title."

Because both *California Family Code* § 852(a) and *California Evidence Code* § 662 are statutory exemptions to *California Family Code* § 760 and yield conflicting characterizations of the property, the court undertook an extensive examination of California law regarding the evidentiary presumptions of *California Family Code* § 852(a), California's marital property transmutation

statute and *California Evidence Code* § 662, California's general presumption of record title in order to determine which rule to apply.

After its exhaustive review, the court applied the holding in *Marriage of Valli* that third-party transactions are not exempt from the requirements of the transmutation statutes and stated that the Trustee could rebut the evidentiary presumption under *California Family Code* § 760 only by proving by a preponderance of the evidence that Wife and Husband transmuted the property from community property pursuant to the requirements of *California Family Code* § 852(a).

At the evidentiary hearing, Wife and Husband testified that they purchased the Real Property in 2009 during their marriage, that record title they took in the Real Property as joint tenants was not something they intentionally chose, but was something that the real estate agents put down, that their understanding was that the Real Property was community property as property acquired during their marriage, that they made no contemporaneous agreement among themselves to specify that title was to be taken as joint tenants and treated as separate property, that they used their community property funds from the proceeds from the sale of their Tarzana house acquired during marriage to make the down payment on the Real Property, that they used their community property funds from the income from Husband's community property business generated during marriage to make the mortgage payments on the Real Property and that at no time did they intend to transmute the Real Property from community property to separate property through any written agreements with each other (*i.e.,* the community funds used to purchase the Real Property were not transmuted into separate property) in accordance with the statutory formalities of *California Family Code* § 852(a).

The trustee presented evidence that after the Real Property was acquired, both Wife and Mr. Obedian made separate statements that the Real Property was held in joint tenancy. On Schedule A to her bankruptcy petition, Wife listed the Real Property as being held in joint tenancy. Further, in Trustee's separate adversary proceeding against Husband for authorization to sell real property of his co-owned interest, Husband stated in his answer that he held a 50-percent interest in the Real Property. On cross examination, Wife and Husband testified that they were represented by a broker when they purchased the Real Property in 2009 and that they signed the escrow instructions.

The court determined that these statements separately or in total did not prove by a preponderance of the evidence that Wife and Husband, by taking tile in joint tenancy, transmuted the Beverly Hills property from community property in order to rebut the California *Family Code* § 760 presumption. Therefore, the property was community property in which each spouse had a 50-percent ownership interest.

The Bankruptcy Code provides that "the debtor may avoid the fixing of a judicial lien or a nonpossessory, nonpurchase-money security interest lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under 11 U.S.C. § 522(f)(2)(A)."

A lien shall be considered to impair an exemption to the extent that the sum of—(i) the lien; (ii) all other liens on the property; and (iii) the amount of the exemption that the debtor could claim if there were no liens on the property exceeds the value that the debtor's interest in the property would have in the absence of any liens.

Because the property was determined to be the community property of Wife and Husband, and each of them has a 50-percent fractional ownership interest in the Real Property, the Bankruptcy Court applied the specific formula under 11 USC § 522(f) and determined that the judgment lien impaired Debtor Wife's homestead exemption under 11 USC § 522(f)(2)(A) and could be avoided under 11 USC § 522(f)(1). The court granted Debtor Wife's motion to avoid the lien.

The authors question the result of the decision in Obedian case. As previously discussed, the presumption that spouses hold property as community property only applies upon divorce. A bankruptcy proceeding is different from a dissolution proceeding where spouses are dividing community property. Therefore, it could be argued that the court in Obedian should not have applied the community property presumption and transmutation rules over the title presumption.

Transmutation Agreements Must Be Clear

It is important to note that the California Courts have issued opinions in many cases as to what will (or will not) satisfy the requirements of the transmutation statutes.

The case of *MacDonald Est.*[15] was the first significant case to address this transmutation issue head on. In this case, the Court exposed a defective attempt to create a transmutation. The writing requirement must be clear concerning change of character and this case is a good example.

MacDonald was an action by the decedent's Wife's children to establish Wife's community property interest in the value of the Husband's IRA accounts. The evidence relating to the alleged transmutation was uncontroverted. Prior to Wife's death from cancer, Wife and Husband intended and attempted to completely divide the community estate so that Wife's children by a prior marriage would receive her

share of the community property and Husband's children from a former marriage would receive his share. The trial Court found that in signing a consent to certain agreements in connection with the Husband's IRA accounts, Wife intended to transmute her community property interest in those funds to the Husband's separate property.

The California Supreme Court reversed the Appellate Court, on grounds that the documents purportedly transmuting the IRA interest did not meet the writing requirements of *Civil Code* § 5110.730 (which is now *Family Code* § 852). The Court expressly disregarded the parties' intent interpreting what is now *Family Code* § 852 as an absolute bar to enforcement of a technically insufficient writing.

The next important case to address a complicated transmutation fact pattern was *In re Marriage of Barneson.*[16] Husband provided written instructions to his investment people at Schwab to "transfer" his Marina Oil stock into Wife's name or to "journal" stock in his Schwab account into Wife's account. The Appellate Court rejected Wife's reliance on California Evidence Code § 662 to argue that Husband failed to rebut the statutory presumption that she held full beneficial title to the stock placed in her name. The court ruled that the term "transfer" might or might not refer to a change of ownership. The term "transfer" could have several definitions. This demonstrated an ambiguity in husband's written direction.

Transmutation Cannot Be Conditional

The Court in the case of *Marriage of Holtemann*[17] held that transmutations cannot be conditional. Even though a transmutation agreement may be executed for purposes of estate planning, the characterization as community property will not be limited only for estate planning if there is a later divorce. Once a valid transmutation occurs, regardless of intent, it is valid and enforceable. In the *Holtemann* case, Husband and Wife married in 2003 and separated in 2006. During marriage, the parties retained an attorney to prepare estate planning documents. The attorney prepared a written Transmutation Agreement and Trust which the parties executed in 2005. An introductory provision in the Transmutation Agreement stated that "[t]he parties are entering into this agreement in order to specify the character of their property interests pursuant to the applicable provisions of the *California Family Code*. This agreement is not made in contemplation of a separation or marital dissolution and is made solely for the purpose of interpreting how property shall be disposed of on the deaths of the parties." The parties also acknowledged that their attorney had explained the "legal consequences" of the agreement, and that they had decided not to retain separate counsel after being advised of the advantages of doing so:

> Article 2.1 of the Transmutation Agreement stated as follows: "Transmutation of Husband's Separate Property to Community Property. Husband agrees that the character of the property described in Exhibit A (including any future rents, issues, profits, and proceeds of that property) is hereby transmuted from his separate property to the community property of both parties. Exhibit A is attached to and made part of this agreement."

One of the more interesting issues that have led to different conclusions is whether a couple can convert community funds to separate funds merely by using community funds to purchase property and then taking title in that property as joint tenants.

> Article 1.3 of the Trust provided: "Statement of Intent. This is a joint trust established by the settlors in order to hold community property of the settlors, which community property was created by the transmutation of separate property of settlor Frank G. Holtemann concurrently with the execution of this trust instrument."

At the bifurcated trial in the dissolution proceeding on the validity of Transmutation Agreement, the trial court found that under express terms of the agreement, Husband had transmuted his separate property to community property. Husband appealed. The question before the court was whether the Transmutation Agreement and the Trust were sufficient to establish Husband's express intent to transmute his separate property to community property, as contemplated by Code Sec. 852, given the fact that language in both documents indicated that they were executed solely for estate planning purposes. The court said:

> "In deciding whether a transmutation has occurred, the court interpreted the written instruments independently, without resort to extrinsic evidence. The court concluded that an express declaration of transmutation does not necessarily require use of the terms "transmutation," "community property," or "separate property."

> The court found that this was a valid transmutation. The Transmutation Agreement unambiguously stated that "Husband agrees that the character of the property described in Exhibit A (including any future rents, issues, profits, and proceeds of that property) is hereby transmuted from his separate property to the community property of both parties."

The Trust similarly provided that it was created in order to hold community property of the settlors, which community property was created by the transmutation of separate property of Husband concurrently with the execution of this trust instrument.

Regardless of the motivations underlying the documents, the documents contained the requisite express, unequivocal declarations of a present transmutation. Moreover, the documents reflected that Husband was fully informed of the legal consequences of his actions. The court stated:

> "Here we are presented with such a clear expression, in the form of an express agreement to transmute property transferred into a trust established for the same purpose. We conclude that a present transmutation of separate property to community property was thereby effected, notwithstanding language in the transmutation agreement and trust that purports to qualify, limit or condition the transfer upon the death of either spouse. Once the character of the property has been changed, a "re-transmutation" can be achieved only by an express agreement to that effect that independently satisfies the requirements of subdivision (a) of § 852."

Parties Must Consider Reimbursement Rights

In dealing with transmutation issues or in drafting transmutation agreements, it is crucial that the parties or lawyers consider the impact of *California Family Code* § 2640 which provides:

> (a) "Contributions to the acquisition of property," as used in this section, include downpayments, payments for improvements, and payments that reduce the principal of a loan used to finance the purchase or improvement of the property but do not include payments of interest on the loan or payments made for maintenance, insurance, or taxation of the property.
>
> (b) In the division of the community estate under this division, unless a party has made a written waiver of the right to reimbursement or has signed a writing that has the effect of a waiver, the party shall be reimbursed for the party's contributions to the acquisition of property of the community property estate to the extent the party traces the contributions to a separate property source. The amount reimbursed shall be without interest or adjustment for change in monetary values and may not exceed the net value of the property at the time of the division.
>
> (c) A party shall be reimbursed for the party's separate property contributions to the acquisition of property of the other spouse's separate property estate during the marriage, unless there has been a transmutation in writing pursuant to Chapter 5 (commencing with § 850) of Part 2 of Division 4, or a written waiver of the right to reimbursement. The amount reimbursed shall be without interest or adjustment for change in monetary values and may not exceed the net value of the property at the time of the division.

Often times, the reimbursement rights derived from Family Code § 2640 in a dissolution of marriage action are not considered or are overlooked, and parties are surprised to find that a transmutation from separate property to community property bring with it a reimbursement claim of substantial value that has not been waived.

Income Tax and Community Property

In *Poe v. H.G. Seaborn,*[18] Seaborn and his wife were residents of the State of Washington, a community property state. The couple reported income on Seaborn's wages, as well as interest on bank accounts and bonds, dividends and profits from the sale of real and personal property. The husband and wife each reported one-half of the income on their respective tax returns and each of them filed as a single person, as there were no joint returns in existence at the time. The IRS contended that all of the income should have been reported by Seaborn. The Court held that State law controls in determining the ownership of property and that according to State law, the wife had a vested interest in the community property equal to that of the husband, including an interest in the income of the husband from salaries or wages. Therefore, the spouses may report one-half of the husband's income on their respective tax returns.

In *R.D. Robbins, Jr.,*[19] the husband divided his wages between his wife and himself and filed his tax return showing 50 percent of the wages and his wife's tax return showing the other 50 percent of wages. The IRS contended

that because the husband had broad powers of control of community property at the time in question, the salary was deemed his. The Court agreed with the IRS and held that the husband's control of the property under California law made it his.

As a result of the *Robbins* case, the California legislature amended the community property laws of California in 1927 to make it abundantly clear that the wife had a vested interest in community property assets. In *R.K. Malcolm,*[20] a California married couple decided to divide the wages of the husband by filing two tax returns, one for the wife and one for the husband and this took place after the amendment to California's community property laws. The Supreme Court ruled that property rights are determined by State law, and that the couple was allowed to divide wages.

Joint Income Tax Return Finally Passes

Community Property States had a huge advantage over separate property states as married couples were permitted to split their wages in half. This caused several States to adopt for a short time community property laws[21] and led to many hearings in Congress calling for an amendment to file a joint return. Proposals to equalize the tax treatment of married couples were floated in 1933, 1934, 1937 and 1941, but none of the proposals were ultimately adopted. The closest that Congress came to making changes to the tax system came in 1941, when the House Ways and Means Committee proposed a mandatory joint return, with married couples to be taxed on their combined income without the option to file separate returns and without the option of applying community property laws which would have resulted in a tax increase on all two-income married couples.[22]

Is Illegal Income Deemed Community Income Under the Internal Revenue Code?

Code Sec. 66 Can Be a Powerful Tool

In *Phyllis M. Curtis Berenbeim*,[23] Taxpayer's ex-husband had obtained money by way of Ponzi scheme. The ex-husband never told the wife about the money and never filed returns for the years in question. The wife had money of her own during that time and provided to her then-husband joint returns that she believed he filed, although the ex-husband never did. Taxpayer was eventually contacted by the IRS. She then showed them a photocopy of the returns she thought were filed. Thereafter, the Ponzi scheme failed and the IRS made an inquiry to the husband who gave the agents the photocopies of the returns, who then filed them without original signatures.

Taxpayer contended that she was an innocent spouse under either Code Sec. 6013(e) or under Code Sec. 66(c). Taxpayer also contended that the illegal income of her ex-husband was not community income and that the returns filed were not joint returns for purposes of Code Sec. 6013(e). Taxpayer made a three-pronged argument as to why she is not liable for the Ponzi scheme money:

1. No valid returns were filed for the tax years in question;
2. Without the joint returns being filed, the unreported income of the Ponzi scheme is not reportable by her under California Community Property Laws; and
3. If the unreported income is deemed to be community property income, she is entitled to innocent spouse relief under Code Sec. 6013(e).

The first question was whether a joint return was filed. Taxpayer contended that for a joint return to be valid, there need be original signatures. The IRS contended that a joint return is filed when two events occur: (1) the return is received by the location designated by the code and regulations, and (2) the taxpayer intends to file the joint return as reflected by his or her objective manifestations.

The Court held that the issue is whether the wife intended to file a return when the return was delivered to the assigned Revenue Officer. At the time the returns were provided to the Officer, the wife believed that the joint returns had already been filed. There was no express or implied intent to file the returns when given to the agents by either spouse.

The second question was whether the income derived from the Ponzi scheme was community income. Under California law, the earnings of either spouse during marriage are the parties' community property. In order for property to be deemed community property under California law, one spouse must have title to the property before it can become community property.

Under California law, a finding of theft by larceny by trick or device consists of appropriation of money or property, possession of which was fraudulently acquired and usually results when the victim intends it shall be applied to a special purpose, as a loan, to enable defendant to carry out some special plan, as an investment, or for the purchase of property, which money defendant intended to appropriate to his own use. In such instances, title does not pass. Here there was theft by trick or device and title never passed as the victims only intended to make a loan.

Finally, the third question was whether the wife is entitled to innocent spouse relief if unreported income

is deemed to be community property. The husband had purchased a number of properties in the wife's name and the wife was aware of those properties. There were gains on the sale of those properties, part of which was attributable to the wife. The Court there looked to the rules under Code Sec. 66(c), noting that the spouse seeking relief has not filed a joint return for any tax year. Furthermore, the income omitted from the gross income of the spouse seeking relief would be treated as the income of the other spouse under Code Sec. 879(a). The spouse seeking relief established that she did not know of and had no reason to know of such item of community income. Finally, under the facts and circumstances, it is inequitable to include such item of community income in the income of the spouse seeking relief.

The Court specifically focused on the latter two points. The standard to be applied in determining knowledge is whether a reasonable person under the circumstances of the taxpayer at the time of signing the return could be expected to know of the understatement.

The Court found that the wife knew of the real estate activity, was aware that she was a nominee on various real estate holdings and attended various closings and signed documents. The Court held that with her actual knowledge and her education background (she held a Bachelor of Science degree and a supervisory credential from USC), she met the knowledge requirement. Finally, the Court held that it was not inequitable to hold her liable as she moved from an apartment to a home with a purchase price exceeding $300,000 and she had a sizeable inheritance along with her separate salary.

Estate Tax and Community Property

California has a long history dealing with community property and estate tax issues. In *Goodyear,*[24] the spouses were married in California on August 18, 1891, and remained residents of California. The law at the time deemed the wife to have only "expectancy" in community property. Because the husband was deemed to have management and control of the property, for income tax purposes, the income earned by the husband could not be divided between the parties and had to be included solely on the husband's tax return. This occurred long before Congress allowed the filing of joint tax returns and due to the progressive tax rates, the husband paid substantially more tax than the couple would have, had they been allowed to divide the income. In Goodyear, the husband predeceased the wife and the Court held that all of the community property must be included in his estate for estate tax purposes.

On July 29, 1927, the community property laws were amended where the law then made it clear that a wife's interest was no longer an "expectancy" interest but rather a present interest in community property. After amendments to the civil code became effective in 1923 and 1927, questions as to the divisibility of community property became at issue in numerous lawsuit, including the case involving the Goodyears. On January 1, 1931, the Goodyears entered into an agreement to alter their legal relations with respect to their property from a mere expectancy interest to a present and equal interest in the community property.

The husband died in 1933, and the issue presented in that case was whether community property could be split between husband and wife. The court in that case held that the husband and wife held an equal but separate interest in community property. Therefore, only the husband's interest in the community property is held to be includible for estate tax purposes and the wife has such an interest in community income that she may separately report and pay tax on one-half of such income.

In *M.I. Siegel,*[25] Taxpayer and her deceased husband were residents of California and the property in question was acquired subsequent to 1927 (*i.e.,* where the law in California provided that each spouse had a vested interest in community property notwithstanding that the husband had management control over the property). The decedent's will provided Taxpayer the right to take under the will, but which required her to waive any rights in her community property, and where taking under the will resulted in a life estate for Taxpayer and thereafter the property would be distributed to their adopted son. After consulting with professionals, Taxpayer determined that taking under the will would more likely result in her being able to maintain her standard of living for the rest of her life. The IRS contended, and the tax court confirmed, that the surrender of Taxpayer's community property rights was a gift to the estate to the extent that the value of the interest surrendered exceeds the value of the interest she received under the will.

The Court of Appeals ruled that this case is contrary to cases in separate property states.[26] Under California law, each spouse owns a community interest in the property and upon the death of the husband, the only thing different is the minor issue of control which is lost. When the husband makes a testamentary disposition of more than half of the community property and the wife chooses to take under the will, the half interest in the estate which she surrenders in a contract is deemed to be supported by adequate consideration.

Community Property vs. Joint Tenancy

Numerous cases also address the issue of whether there has been a transmutation of property from community to joint tenancy. In *J.S. Pierotti,*[27] Decedent and Taxpayer held property as joint tenants. Taxpayer filed the Estate Tax Return listing property as held in joint tenancy but stated that it was also community property. If the property was to be treated as joint tenancy, the entire value of such property would be included in the estate but if it were treated as community property, only one-half would be includible in the estate.

The court looked to State law to determine the character of property. Parole evidence was introduced in which it was shown that Taxpayer and decedent had retained an attorney for the purpose of vesting title as "post-1927" community property. The trial court found that the decedent and Taxpayer orally agreed to vest their property as community property and granted Taxpayer a refund on the Estate tax return.[28] The attorney had erroneously advised Taxpayer and decedent to make a deed to each other as joint tenants. The court held that the law is well settled that common-law forms of conveyance should not alter the community character of the property contrary to the intention of the parties.

In *Wayne-Chi Young Est.,*[29] the court found that the husband and wife there did take title to property as joint tenants because the evidence presented could not overcome the presumption of joint tenancy. There, the Youngs had acquired numerous properties under as joint tenants. The surviving spouse took the position that the real properties constituted community property and the estate was entitled to a fractional discount for the properties held in joint tenancy.

The court looked to state law to determine the nature of decedent's interest in the property. Although under California law, property acquired by spouses is presumed to be community, where spouses take property as joint tenants, such presumption is rebuttable by evidence presented. The surviving spouse petitioned the court and contended that filing a spousal property petition in the Superior Court of California and alleged that the Young Property was community property. Petitioner argued that the language in the decedent's will transmuted the property from joint tenancy into community property. The court rejected the petitioner's arguments and found that the petitioner did not present sufficient evidence to support a finding that the decedent intended to transmute the Young property from joint tenancy into community property. Because the court found that the evidence presented by petitioner did not overcome the presumption of joint tenancy, the decedent and the surviving spouse held the Young Property as joint tenants with the right of survivorship.

The court also rejected issues raised as to a fractional interest discount because the includible amount did not depend on valuation of property rights transferred at death. With respect to community property, each spouse owns a one-half interest[30] in the community property and each spouse's interest is deemed separately owned so that the decedent has no interest in the surviving spouse's share of the community property. On the other hand, at death, a decedent cannot devise a joint tenancy interest held by the decedent. The court looked to Code Sec. 2040, holding that Code Sec. 2040(a) starts with the inclusion of the entire value of the joint tenancy property held by the decedent and any other person in the joint estate of the first tenant to die, and the amount to be excluded from the decedent's gross estate is proportionate to the consideration furnished by the survivor.[31] The court went on further to hold that under the scheme of Code Sec. 2040, the amount included in a decedent's gross estate did not depend on a valuation of rights actually transferred at death or on a valuation of the interest held by the decedent. The decedent's gross estate included the entire value of the property held in a joint tenancy by him and any other person, except to the extent that another person furnished consideration. The statute did not inquire into what a willing buyer would pay because at the time of death, decedent holds no interest in the property. Finally, the court found that there were no issues as to a lack of a marketability discount because the court did not find any inherent difficulty in the sale of the property.

However, the taxpayer in these cases failed to argue that the property is community property under the progeny of *Valli* and *Obedian.* Based on those cases, it could be argued that the husband and wife took title as joint tenants solely because escrow put that title on the deeds. Prior to California's adoption of community property with rights of survivorship, most real estate brokers advised their clients to take title as joint tenants to avoid probate. Most taxpayers received very little information on the legal implications of separate as opposed to community property and it may require the surviving spouse to file a declaration delineating all the facts surrounding how the couple took title.

As discussed above, joint tenancy is deemed to be separate property from a tax standpoint. Family Law attorneys have always viewed joint tenancy property as community property, but the family law attorneys are generally looking at end from a dissolution standpoint as opposed to a tax standpoint. California's Family Law Code states that joint tenancy property is community property for purposes of

dissolution or separation, not tax. From a collection standpoint, it would surely be better off for the IRS to show that the property held by husband and wife or Domestic Partners is community property as opposed to separate property held in the form of joint tenancy. It will be recalled that community property is liable for the separate debt of either spouse as well as any community debt.[32] However, considering the holdings in *Valli* and *Obedian,* has the proverbial Pandora's box been opened for the IRS to argue that even if the property is held in Joint Tenancy, it is still community since it was never properly transmuted?

Conclusion

An understanding of California's community property laws is essential for a tax practitioner to properly advise his or her clients. From a tax controversy perspective, it is important to be able to distinguish between community property versus other forms of holding property. If property is held in joint tenancy or tenants in common, it is considered separate property by the IRS. Thus, if only one spouse is liable for a tax debt, the IRS is limited to only going after that spouse's interest in the property in question. From an estate plan perspective, as opposed to an asset protection perspective, it would surely be in a Domestic Partnership or marriage for the property to be held as community to get a step-up in basis on both halves of the property in the event of the death of one spouse.

Although it is clear that Joint Tenancy property is not community property for income or estate tax purposes. Nevertheless, State law controls the nature and character of property. Considering the recent holding in *Valli* and *Obedian*, it appears that a practitioner who really understands community property and the issues revolving transmutation might be able to argue that property held in joint tenancy is community property notwithstanding how the married couple or Domestic Partners took title to the property. Similarly, it may give the IRS additional more arsenal to assert that property held as joint tenants is really community property for collection purposes.

ENDNOTES

1 *R.F. Drye, Jr.,* SCt, 99-2 USTC ¶51,006, 99-2 USTC ¶60,363, 528 US 49, 120 SCt 474.

2 There are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Alaska and Tennessee have adopted community property systems, but it is optional.

3 CA Family Law Code §§ 760 and 752.

4 CA Family Law Code §760.

5 CA Family Law Codes §§770(a)(1) and (3); CA Family Law Code §771(a).

6 Common ways of vesting in real property include:
- Tenancy in common
  - Two or more parties, where division of property may be either equal or unequal, and where creation of the interest may be through one or more conveyances.
  - Each party has equal possession and control of the property and the interest is transferrable.
  - Unless the parties are married or domestic partners, co-owner's interest is not subject to liens of the others' debtor, although a forced sale can occur.
  - Upon the death of one co-owner, the decedent's interest passes to his or her devisees or heirs by will or by intestacy.
  - Primary advantage is that the co-owner's interest may be separately transferable.
- Joint Tenancy
  - Two or more natural persons must have equal interest in the property through a single conveyance.
  - Each party has equal possession and control of the property and although interest is transferrable, a transfer would result in the interest to become tenancy in common.
  - One co-owner's interest is not subject to the liens of the other's debtor, but a forced sale can occur prior to that co-owner's/debtor's death.
  - Decedent's interest automatically passes to the surviving joint tenant.
  - Primary advantage is the right of survivorship, although there may be negative tax consequences.
- Community property
  - The parties must be either spouses or domestic partners with equal division of property, and an interest created from a presumption through marriage or domestic partnership.
  - Each party has equal possession and control of the property but interest is only transferrable after mutual consent.
  - The entire property may be subject to a forced sale to satisfy debt of either spouse or domestic partner.
  - Decedent's one-half interest passes to surviving spouse or domestic partner.
  - An advantage is that there are qualified survivorship rights, but mutual consent is required for any transfer of interest.
- Community property with right of survivorship.
  - The parties must be either spouses or domestic partners with equal division of property, but an interest is created either from a single conveyance or through consent (*i.e.,* for domestic partnerships).
  - Each party has equal possession and control of the property but interest is only transferrable after mutual consent.
  - The entire property may be subject to a forced sale to satisfy debt of either spouse or domestic partner.
  - Decedent's one-half interest passes to surviving spouse or domestic partner.
  - Primary advantage is right of survivorship, but mutual consent is required for any transfer of interest.

7 This presumption is for purposes of dissolution of marriage or legal separation of the parties. It does not apply for purposes of transmuting joint tenancy property into community property for estate tax purposes.

8 CA Family Code § 851.

9 *In re Ann Marie Summers,* 278 BR 808 (9th Cir. 2002).

10 11 USC §541(a)(2).

11 *In re Pavich,* 191 BR 838, 844 (Bankr. E.D. Ca. 1996).

12 *In Re. John T. Gorman*, 159 BR 543 (9th Cir. 1993).

13 *In re Marriage of Valli*, 58 Cal. App. 4th 1396 (2014).

14 *In re Obedian,* 546 BR 549 (2016).

15 *MacDonald Est.,* 51 Cal3d 262, 272 (1990).

16 *In re Marriage of Barneson,* 69 Cal. App. 4th 585 (1999).

17 *Marriage of Holtemann,* 166 Cal App. 4th 1166 (2008).

18 *Poe v. H.G. Seaborn,* SCt, 2 USTC ¶611, 282 US 101, 51 SCt. 58 (1930).

19 *R.D. Robbins, Jr.,* SCt, 1 USTC ¶154, 269 US 315, 46 SCt 148 (1926).

20 *R.K. Malcolm,* SCt, 2 USTC ¶650, 282 US 792, 51 SCt 184 (1931).

[21] States enacting community property laws temporarily include Michigan, Nebraska, Oklahoma, Oregon, Pennsylvania as well as Hawaii.

[22] As Boris Bittker explains: (T)wo unmarried taxpayers with separate sources of income would have to pay a heavier tax if they got married than if they lived together without benefit of clergy, and many married couples would be able to reduce their tax burden by getting divorced. Quite naturally, therefore, opponents of the proposal assailed it as "a tax on morality." The proposal was never enacted, so the inequality between common law and community property states continued through World War II. Some common-law states began taking matters into their own hands: Oklahoma led the way, enacting community property provisions in 1939. Hawaii, Michigan, Nebraska, Oregon and Pennsylvania would follow Oklahoma's lead. Proposals to enact community property law were also debated in Massachusetts and New York, but were never passed. Finally in 1948, Congress acted. For the first time, filing statuses were created and we moved closer to the tax system we know today.

[23] *Phyllis M. Curtis Berenbeim,* 63 TCM 2975, Dec. 48,209(M), TC Memo. 1992-272.

[24] *Goodyear,* CA-9, 38-2 USTC ¶9532, 99 F2d 523.

[25] *M.I. Siegel*, CA-9, 57-2 USTC ¶11,731, 250 F2d 339.

[26] Where a widow's dower rights are involved as the spouse's dower rights only vest upon the death of the husband and becomes a "purchaser for value." In other words, the spouse is a purchaser for value in accepting the provisions of the will and is not treated as a gratuitous object of the testator's bounty. By a relinquishment of her dower, the estate acquires a valuable right of property. The gift by will *in lieu* of the other right (dower right) is said to be equivalent to an offer, and to offer something to the devisee in return for his property or interest.

[27] *J.S. Pierotti*, CA-9, 46-1 USTC ¶9230, 154 F2d 758.

[28] Note that oral transmutations were permitted at the time.

[29] *Wayne-Chi Young Est.,* 110 TC 297, Dec. 52,691 (1998).

[30] Code Sec. 2033.

[31] Code Sec. 2040.

[32] CA Fam. Code §910(a).