

# COMMUNITY PROPERTY ISSUES IN ESTATE PLANNING

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# THE ISSUE OF TRANSMUTATION IN ESTATE PLANNING

## I. INTRODUCTION

- a. What is transmutation?
  - i. Separate to CP (purpose: basis step-up, security for spouse with less property)
  - ii. CP to SP (funding gifts to ILITs, funding QPRTs or GRATs)
  - iii. SP to SP (Gifts from one spouse to the other)
- b. When is transmutation an issue in estate planning?
  - i. Intentional transmutation
    - 1. Tax planning – Income tax basis
    - 2. Asset protection – Public benefits planning
  - ii. Unintentional transmutation
    - 1. Can occur if a party cannot rebut the presumption of undue influence if one spouse gains an advantage over the other
    - 2. Estate planning that may have the unintentional effect of transmutation

## II. TRANSMUTATION – LEGAL REQUIREMENTS

- a. By Written Agreement – Family Law § 852
  - i. Writing
  - ii. Express declaration of transmutation
    - 1. The writing must contain language that expressly states that a change in the characterization or ownership of property is being made. *Estate of MacDonald*, (1990) 51 Cal. 3d 262
    - 2. Need not use the word “transmutation” or any other particular terms. *Marriage of Lund*, (2009) 174 Cal. App. 4<sup>th</sup> 40, 50
  - iii. Joined in by spouse adversely affected
  - iv. Recorded to be enforceable as to third parties in relation to real property
- b. By commingling
  - i. Case law elements

### III. CALIFORNIA LAW- ITEM THEORY VS. AGGREGATE THEORY

#### a. ITEM THEORY (DEFAULT)-

- i. A spouse may dispose of a one-half interest in each item of community property. *Estate of Wilson*, (1986) 183 Cal.App.3d 67
- ii. A spouse is entitled to spouse's one-half interest in each TOD account, regardless that decedent's transfer to spouse equaled one-half of the total. *Estate of Miramontes* (2004) 118 Cal. App.4<sup>th</sup> 750.

#### b. AGGREGATE THEORY- A spouse may dispose of any half of the whole of the community property assets, but not more than one-half.

c. Prob. Code § 100(b) provides that spouses may agree in writing to use the item theory or the aggregate theory, or partly on each. Aggregate Agreement is not a transmutation.

#### d. Hypothetical

- i. Spouses own a house worth \$2 million and hold it in an A/B trust. Husband has \$1 million IRA that is community property, wife is primary beneficiary. The total community estate is \$3 million (trust and non-trust property). Husband dies. Decedent's Share = \$1 million (1/2 of trust estate). Survivor's Share = \$ 2 million (1/2 of trust estate plus IRA)
- ii. Same facts but couple has written agreement for non pro rata division of the aggregate value of the entire community estate, both trust and non-trust property. Decedent's Share = \$ 1.5 million (1/2 of the trust property plus an additional allocation from the trust estate to offset IRA). Survivor's Share = \$1.5 million (\$1 million IRA plus \$500k from trust estate)

### IV. THE BURDEN OF PROOF

- a. What is the burden of proof and who must satisfy it? When a spouse alleges that there has been a transmutation, that spouse has the burden of proving, by clear and convincing evidence, that a transmutation occurred. *Marriage of Weaver*, (1990) 224 Cal. App. 3d 478, 486
- b. How can a person satisfy the burden of proof (rules of evidence)?

- i. A statement in a will of the character of property is not admissible as evidence of a transmutation in a divorce. Fam. Code § 853
- c. Probate Code
  - i. Holding assets in a joint trust does not transmute assets to CP

## V. COMMON EXAMPLES IN ESTATE PLANNING

- a. Written Agreement
  - i. Revocable trusts
    - 1. A revocable trust providing that all property transferred to it is community property is not an effective transmutation. *Marriage of Starkman*, (2005) 129 Cal. App. 4<sup>th</sup> 659
    - 2. Does “Schedule of Assets” attached to Trust satisfy written agreement? General assignment?
      - a. Spouse instructs attorney to list separate property assets on schedule A. At divorce, this spouse asserts this property is separate property.
      - b. No transmutation if the writing does not contain language that state that a change in characterization is being made.
    - 3. Real property- required language in a deed
    - 4. Transmutation Agreements
      - a. Court must consider every transaction for unfair advantage before characterizing property as separate or community. Fam. Code § 721(b)
      - b. Spouses cannot make a transmutation agreement that is effective only at death, it is effective for all purposes including the division of property on divorce. *In re Marriage of Holtemann*, (2008) 166 Cal.App.4<sup>th</sup> (2008)
    - 5. Postnuptial Agreements
      - a. Spouses have fiduciary duties to each other and any transaction that benefits one spouse unfairly at the expense of the other is presumed to be the result of undue influence. *Marriage of Haines*, (1995) 33 Cal. App. 4<sup>th</sup> 277

- b. Postnuptial agreements are difficult to uphold because of the presumption of undue influence if one spouse gains advantage over the other. The burden of proof is on the advantaged spouse to prove by a preponderance of the evidence that there was no undue influence and no violation of spousal fiduciary duties.

6. Alternative Arrangements; e.g. Separate Property Trusts

b. Commingling

i. Bank Accounts

- 1. Jointly titled accounts are presumed to be community property unless a spouse can adequately identify and trace source and funds of separate property. *In re Marriage of Mix*, (1975) 14 Cal. 3d 604

ii. Family Business

- 1. Community property efforts in separate property family business

iii. Real Property

- 1. Separate property down payment with community property mortgage payments

iv. Non Probate Assets - retirement accounts and life insurance

**VI. ETHICAL CONSIDERATIONS**

a. Attorneys

i. Conflict of interest: Illustration – competing interests, such as transmuting assets from SP to CP

- 1. Each spouse should have independent counsel
- 2. Make sure each spouse understands the transmutation and document their understanding

ii. Confidentiality: Illustration – duty to disclose assets

- 1. Joint representation- Attorney cannot withhold asset information from the other spouse
- 2. Single representation- Attorney must advise client that they owe fiduciary duties to their spouse; violating these duties will invalidate their planning/agreements/transactions

iii. Duty of Inquiry

- 1. How far must an attorney go to determine the characterization of property?
  - a. Ask clients probing questions to discover facts that support or contradict the characterization

- b. Advise clients in writing that you are relying entirely on the representation of the parties as to the characterization of property
    - c. Advise clients in writing that any schedules of community and separate property that will be included in the estate plan will be based entirely on the parties' representations
  - 2. Duty of Competence
    - a. You must be able to spot the issues
    - b. Advise clients in writing if characterization is ambiguous
- iv. Fraudulent transfers (asset protection)
  - 1. Illustration – transferring assets from one settlor SP to another settlor as SP to avoid creditors
  - 2. Transmutations are subject to the laws governing fraudulent transfers.
  - 3. *State Board of Equalization v. Woo*: Wife attempted to transmute her community property earnings to her separate property to avoid wage garnishment for Husband's tax debt. The court found that the attempted transmutation was a fraudulent transfer.  
(2000) 82 Cal. App. 4<sup>th</sup> 481
- b. Clients
  - i. Fiduciary duty to spouse
    - 1. Disclosure of assets- Fam. Code § 1100 imposes a duty to make full disclosure to the other spouse of all material facts and information on the existence, characterization, and valuation of community property assets.
      - a. Fam. Code 1100 does not create a duty to disclose separate property during the marriage because separate property is not subject to equal ownership and control. *In re Schleich*, (2017) 8 Cal. App. 5<sup>th</sup> 267, 279
      - b. However, Fam. Code § 2104 encompasses a duty to disclose separate property assets in a dissolution proceeding
    - 2. Rebut presumption of undue influence by showing that the disadvantaged party entered into the transaction freely and voluntarily, with full knowledge of all relevant facts, and with full understanding of the consequences of the transaction.

## VII. CONCLUSION

- a. Summary of issues
- b. Practice tips
  - i. Encourage separate counsel
    - 1. To advise each spouse about the benefits and risks of transmutation
    - 2. Helpful to rebut the presumption of undue influence
  - ii. Encourage clients to establish separate estate plans if there is significant separate property
    - 1. Reduces risk of commingling
    - 2. Reinforces separate property characterization
  - iii. Estate Planning Attorney's Arsenal if called as a witness in dissolution proceeding
    - 1. Documents that evidence:
      - a. The spouses' intentions
      - b. The spouses were advised to seek independent legal advice
      - c. The spouses were warned about potential conflicts of interest
      - d. The spouses understood the effects of property characterization and the consequences of transmutation
    - 2. Transmittal letters to show that clients received copies of all relevant documents.
  - iv. Drafting tips for making gifts to children to protect separate property character
    - 1. Make large gifts to children in irrevocable trusts, especially when the gift is business interests or cash intended to purchase business interests
    - 2. Consider lifetime trusts for children with broad distribution powers and power to withdraw to protect against inadvertent commingling

# CALIFORNIA'S NEW DECANTING LAW

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# DECANTING

## I. INTRODUCTION

Decanting is a way to modify irrevocable trusts without court order by transferring assets from the first trust to a second trust that has modified terms. The Uniform Law Commission approved the Uniform Trust Decanting Act (UTDA) in 2015. California passed a modified version of the UTDA that contains additional safeguards to protect the settlor's intent and the beneficiaries' interests. California's UTDA became effective on January 1, 2019.

If the first trust does not provide otherwise, the terms of the first trust are deemed to include the decanting power. This includes trusts created on or before the CUTDA effective date. You should look at your clients' existing irrevocable trusts and determine whether decanting would be beneficial. Decanting would be particularly useful for getting a step up in basis for assets in a Bypass Trust.

### a. Differences between UTDA and CUTDA

- i. CUTDA requires notice to minors and unascertained or unborn persons. If such a beneficiary has no representative, the trustee must seek appointment of a guardian ad litem. The statute is ambiguous as to whether an unborn beneficiary requires a GAL.
- ii. CUTDA requires that a beneficiary bring a court action to contest the exercise of the decanting power. UTDA does not expressly state that a court action is necessary.

## **II. USES OF DECANTING POWER**

Correct drafting errors, achieve tax benefits, update administrative provisions such as trustee succession, create special needs trust for disabled beneficiaries.

## **III. EXERCISE OF DECANTING POWER**

- a. The trustee must give notice in a signed writing to all parties entitled to notice not less than 60 days before the exercise of the decanting power.
- b. Parties Entitled to Notice: each settlor of the trust, each qualified beneficiary of the first trust, each holder of a presently exercisable power of appointment over the first trust, each person that currently has the right to remove or replace the trustee, each other trustee of the first trust, each proposed trustee of the second trust, and the Attorney General if the first trust contains a determinable charitable interest.
- c. The noticed parties need not consent to the exercise, they must fail to object.
- d. The decanting power may be expressly limited by the trust instrument and by default is restricted by the statute