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Planning in the Context of Marriage

A. Overview

1. Introduction

With respect to property ownership by spouses, all states follow one of two legal systems: common law or community property.

In **common law states**, as a general rule, property acquired by a spouse prior to marriage, and property acquired during marriage and titled in the name of one spouse, is treated as the separate property of that spouse. Creditors of the debtor spouse cannot reach the separate property of the non-debtor spouse, with the limited exception for necessities of life.

In **community property states**, most property acquired during marriage is treated as community property. Even if property so acquired is titled in the name of one spouse, that merely creates a rebuttable presumption as to the community or separate nature of such property. Because each spouse has a coextensive ownership interest in community property, creditors of either spouse can reach all community property of the two spouses.

2. Common Law Jurisdictions

Most states in the United States follow the common law. In a common law state, property titled in the name of one spouse is treated as the separate property of that spouse. This means that (i) only the titled spouse has control over that property; (ii) the titled spouse can gift such property without the consent of the other spouse; and (iii) only the creditors of that spouse can reach his or her separate property. The separately titled property of the non-debtor spouse is not liable for the debts of the debtor spouse.

Example: Major Nelson is married to Jeannie and they own a house in Coco Beach, Florida. The house is titled in Major Nelson's name. If Jeannie is sued, the house is unreachable by her creditor, because it is titled in Major Nelson's name, and is his separate property.

Planning in a common law state is relatively straight-forward in light of the above rule. If between the two spouses one is high-risk (likely to get sued because of the spouse's profession or the business the spouse is engaged in) and the other is low-risk (unlikely to get sued), as much of the couple's property as possible should be titled in the name of the low-risk spouse. Accordingly, if one spouse is a demolition contractor and the other grows roses, most of the couple's property should be titled in the name of the green-thumbed spouse.

However, on divorce, the treatment of the spouses' property is different. All property acquired during marriage,[1] regardless of how it is titled, is treated as marital property,[2] and is subject to a division on divorce.

The distinction that exists in common law states between what property is reachable by a creditor during marriage and subsequent to a divorce is very important. To summarize, during marriage, the creditor can reach only the

[1] Other than by gift or inheritance.
[2] Generally, in a common law state, marital property will be any property owned by a spouse except: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property designated as nonmarital through an agreement between spouses.

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property titled in the name of the debtor spouse. However, on divorce, all marital property will be divided, regardless of how it is titled and may become reachable by a creditor.

Example: If Napoleon is on title to the Elba farm in upstate New York, then Josephine's creditors cannot reach the farm. However, if the farm was acquired during marriage and is thus marital property, when Josephine divorces Napoleon and is awarded a 50% interest in the farm, her creditors can now reach that 50% interest. Thus, in a common law state the timing of a divorce becomes of great importance.

In a common law state, there do not appear to be any disadvantages in titling the bulk of a couple's assets in one spouse's name. During marriage, the assets are not exposed to the creditors of the high-risk spouse, and on divorce the property will be divided based on its classification as marital or nonmarital, and not based on how it is titled.

A creditor's inability to pursue the non-debtor spouse extends to all separate assets of the spouse, including properties and earnings. It also, generally, does not matter how the liability arose, whether through a spouse's tort or a contractual obligation. Only when the debtor spouse acted as an agent for both spouses, can the non-debtor spouse's property be reached.

3. Community Property Jurisdictions

a. Overview of Community Property

In a community property state there are two types of property: separate and community.[3] Separate property is acquired in much the same manner as in common law states: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property acquired during marriage but as to which the spouses entered into an agreement treating it as separate property.[4]

Separate property in a community property state is afforded similar treatment to separate property in a common law state. During marriage, a creditor of one spouse cannot reach the separate property of the other spouse. However, the one important distinction is that in a community property state, separate property is separate for all purposes, including divorce. Recall, that in common law states separate property may also be marital property, subject to an equitable division on divorce.

Community property is a form of joint ownership of property by husband and wife. It is defined as real or personal property, wherever situated, acquired by a married person during the marriage while domiciled in this state. Each spouse can manage, direct and control community property.

The distinctive feature of community property[5] is that both spouses own coextensive interests in all of community property. This means that a creditor of one spouse can reach all the community property of the spouses. California Family Law Code Section 910(a) provides:

[3] There is actually a third form of property in a community property state: quasi-community property. Quasi-community property is real and personal property, wherever it is located, that would have been community property had the spouse been domiciled (resided) in California when he or she acquired it, or any property acquired in exchange for such property. Quasi-community property is treated as community property for liability allocation purposes.
[4] California Family Code Sections 770(a) and 850(a).
[5] Community property states include: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

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> Except as otherwise expressly provided by statute, the community estate is liable for a debt incurred by either spouse before or during marriage, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.

The liability of community property extends to contracts entered into by either spouse during marriage, to torts of either spouse during marriage, and to most pre-marriage obligations of either spouse.

Example: Arnold marries Maria in California, where they continue to live. Prior to marriage Arnold's assets include two barbells and one bottle of body oil. During marriage, Arnold works as an actor and makes $100. Maria's uncle Ted is killed in a drunk-driving accident and leaves her a set of fine china. The spouses have no pre- or post-nuptial agreement.

The two barbells and the bottle of oil are Arnold's separate property. The set of fine china is Maria's separate property. The $100 is community property. If Maria is ever sued, her creditor would look to satisfy its judgment against the set of fine china and $100.

An exception is carved out for earnings of a spouse, which are not liable for pre-marital liabilities of the other spouse.[6] The earnings remain protected even after paid to the non-debtor spouse, provided that the earnings are deposited into a separate bank account.

b. Characterization of Community Property

i. Generally

The five major factors affecting characterization of property as separate or community are the following: (i) time of the property's acquisition; (ii) the source of funds used to acquire the property; (iii) whether spouses entered into a "transmutation agreement" to change the character of property from community to separate, separate to community, and from the separate property of one spouse to the separate property of the other spouse; (iv) actions by parties, including actions that "commingle" or combine separate and community property; and (v) operation of various legal inferences, called "presumptions," that help to determine the character of property.

ii. Timing of Acquisition

The most important factor to consider is the timing of the acquisition. Property owned by a spouse before marriage, as well as rents and income from such property, is separate property of that spouse, unless the spouses entered into an agreement to transmute such separate property into community property.

A community property interest can be created only during marriage.[7] Absent an agreement to the contrary, all property, real or personal, acquired during marriage will be treated as community property.

iii. Source of Funds

- **Tracing**

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[6] California Family Code Section 911(a).
[7] For this purpose, marriage ends with a divorce, or, if earlier, when the spouses are legally separated and are living apart (the "separate and apart" test). Spouses are considered to be living "separate and apart'" from each other when they have come to a parting of the ways with no present intention of resuming marital relations, and in which there is conduct evidencing a complete and final break in the marital relationship.

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When the timing of the acquisition is unclear or not overly helpful in the analysis, other factors must be taken into account in determining the character of property.

The source of funds used to acquire property of a spouse may help determine the character of such property. This stems from the rule that changing the form of the property does not change its character. For example, if a spouse has a bank account before marriage (treated as separate property), then if the spouse uses the funds in that account to acquire a real estate parcel, such parcel will also be separate property.

If property is acquired during marriage with both community and separate property funds, then there is a presumption that such property is community property. That is based on the general presumption that property acquired during marriage is community property. However, this presumption may be overcome by tracing to the separate property funds, and allocating at least a portion of the property to the separate property interest.[8]

• Commingling

For purposes of characterizing property as separate or community, "commingling" means mixing or combining separate and community property into one aggregate. Characterizing commingled property usually requires "tracing" the separate and community contributions back to their respective sources. The mere commingling of separate with community property does not destroy the character of either, provided that their respective amounts can be ascertained.

If property is commingled to such an extent that tracing will not successfully establish its source, then the community property presumption (for property acquired during marriage) cannot be overcome.

The most common type of commingling that take place during marriage involves commingling separate and community funds in a common bank account. There are two ways to trace such commingled property.

Under the ***direct tracing*** method, a spouse may trace funds in a commingled account to separate property by maintaining a set of itemized, chronological records reflecting all the deposits and the withdrawals from the account. Using such records, it should be possible to establish how much separate property of either spouse went into the account, how much community property went in, and how much separate and community property was withdrawn.

It is important to note that it is not sufficient to simply show the availability of separate funds, the expenditure must be traced back to the source of funds. For example, if Lucy buys property during marriage and titles it in her name alone, it is not enough for her to show that she had separate property funds available for the purchase. To overcome Ricky's claim that the purchased property is community, Lucy will have to demonstrate that she not only had separate funds available, but that separate funds were used to purchase the property.

<u>Example</u>: Lucy and Ricky reside in Hollywood and have a bank account with a balance of $30,000. The balance is the result of Ricky receiving a $20,000 gift from his friend Fred (gifts are separate property), and the remaining $10,000 are the community property earnings of the spouses. Ricky uses $12,000 from the account to purchase a drum. Lucy and Ricky decide to divorce. The drum is community property. Ricky cannot trace the funds used to purchase the drum to his separate property funds. Even though Ricky's records show that there was $20,000 of available separate property funds in the account, Ricky cannot show that these funds were actually used to purchase the drum. Thus, because the property is acquired during marriage, it is presumed to be community property.

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[8] If such property is titled in the name of both spouses, then the community property presumption with respect to such property cannot be overcome by tracing. More concrete evidence will be required to establish a separate property interest.

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The other way to trace commingled funds is through the use of the so-called ***family expense tracing*** method. This method works off the legal presumption that family expenses are paid from community funds. This means that if one spouse can establish that all of the community funds in an account were expended to pay for family expenses, then necessarily, the only funds left in the account are separate property funds. However, the family expense tracing method will work only if the spouse maintained sufficient records to trace deposits and withdrawals from the account, and if the community did not generate sufficient earnings to pay for its expenses.

Example: Ron and Nancy open a bank account and deposit $10,000 in community funds. Ron later deposits $5,000 of separate property funds. During the year, the couple spends $12,000 from the account on family expenses. At the end of the year, Ron spends $500 from the account to buy a saddle. The saddle is Ron's separate property, because of the presumption that community property is used first to pay for family expenses.

To avoid the problems posed by commingling, spouses are always advised to: (i) execute and record a separate property inventory that includes all separate property owned at the time of execution; (ii) keep financial records adequate to establish the balance of community income and expenditures at the time an asset is acquired with commingled property; or (iii) avoid commingling altogether and maintain a separate bank account for separate property funds.

- **Improving Separate Property**

If the spouses use community property funds to improve the separate property of one spouse, that does not change the nature of the separate property. The funds expended by one spouse for the improvement of the separate property of the other spouse are presumed to be a gift between spouses (gifts are always separate property).

However, if one spouse used community property funds to improve his or her own separate property without the consent of the other spouse, the community is entitled to a reimbursement.

- **Acquiring Property with both Kinds of Funds**

When property is acquired during marriage using both separate and community property funds, then, if it is possible to trace, the property will be partially separate and partially community. If tracing is unavailable, then the regular community presumption will apply,[9] and the property will be treated as community property.[10]

If property is acquired during marriage with a separate property down payment, and with a loan where the lender relies on the earnings of both spouses, then the loan is community, and thus a portion of the property is separate (the portion attributable to the down payment) and the rest is community. The character of property acquired by a sale on credit or by a loan depends on the intention of the seller or lender to rely on the separate property of the purchaser or to rely on community assets for satisfaction of the debt. The proceeds of an unsecured loan made on the personal credit of either spouse are regarded as community property. Funds borrowed by the pledge of a spouse's separate property are that spouse's separate property. Absent evidence that a seller or creditor relied primarily on the purchaser's separate property in extending credit, the property purchased or money borrowed is presumed to be community property. This result follows the general rule that property acquired during marriage is community property.

[9] California Family Code Section 2581. This presumption provides that property acquired during marriage, regardless of how it is titled, is presumed to be community.
[10] However, even if tracing is unavailable, in certain circumstances, separate property may be entitled to a reimbursement of its contribution. See, California Family Code Section 2640.

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For property acquired during marriage, it is important to establish not only the actual amounts of separate and community contributions, but also their respective proportions. Thus, when the property appreciates in value, it will be still possible to apportion.

- **Pursuing a Separate Business**

When one spouse devotes time during marriage to develop his or her separate business and the business appreciates in value, then a portion of that appreciation is attributable to the community. During marriage the time of each spouse belongs to the community, and the time expanded on a separate business is community's time. California courts have established complicated formulas to apportion the appreciation in value between separate property and community property.

iv. Transmutation

Married persons may, by agreement or transfer, and with or without consideration, change or "transmute" the character of their property in any of the following ways: (i) from community property to separate property of either spouse; (ii) from separate property of either spouse to community property; (iii) from separate property of one spouse to separate property of the other spouse.[11]

To be effective, a transmutation agreement must be in writing, the spouses must fully disclose their properties to each other, and a transmutation of real property will be effective as to third-party creditors only if it is recorded.[12]

The law of fraudulent transfers applies to transmutation agreements.[13]

v. The Community Property Presumption

There is a legal inference, called a "presumption," that all property acquired during marriage by either husband or wife or both is community property.[14]

The general community property presumption specifically applies to the following types of property:[15] (i) all real property, including leased property, that is located in California and is acquired during marriage by a spouse while domiciled (living with intent to remain) in California; (ii) all personal property, wherever located, that is acquired during marriage by a married person while domiciled in California; and (iii) all community property transferred by husband and wife to a trust pursuant to Family Code Section 761.

However, the general community property presumption that property acquired during marriage is community property may be overcome by evidence that the disputed property is actually separate property.

Evidence that may be used to overcome the community property presumption includes the following: (i) an agreement between the parties to change the character of (transmute) the property from community to separate property; (ii) tracing property to a separate property source; or (iii) reliance on separate property as collateral when property is purchased on credit.

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[11] California Family Code Section 850.
[12] California Family Code Sections 852(a) and (b). See, also, Estate of MacDonald, 51 Cal. 3d 262 (1990).
[13] California Family Code Section 851.
[14] California Family Code Section 760.
[15] *Id.*

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If the community property presumption cannot be overcome, the party who has made traceable separate property contributions to the acquisition of property may obtain reimbursement in certain circumstances.[16]

There are several statutory exceptions to the general presumption that all property acquired during marriage is community property: (i) property acquired by either husband or wife by gift, will, or inheritance;[17] (ii) property that either spouse acquires with the rents, issues, or profits from separate property; (iii) property held at death and that a spouse acquired during a previous marriage if that marriage was terminated by dissolution more than four years before death; (iv) any real or personal property interest acquired by the wife by written instrument before January 1, 1975; (v) property acquired by either spouse after separation, unless the property is acquired with community property funds; (vi) property designated as separate by a transmutation agreement; (vii) personal injury damages paid by one spouse to the other spouse if the cause of action arises during marriage; and (viii) personal injury damages received by one spouse from a third party after a court renders a decree of legal separation or a judgment of dissolution of marriage.[18]

vi. Effect of Title on Community Property

• Joint Tenancy and Tenancy in Common

The general community property presumption applies to all property acquired during marriage, including property titled in joint form, such as joint tenancy or tenancy in common. A spouse intending to rebut the community property presumption for jointly titled property may do so in one of two ways: (i) a clear statement in the deed or other documentary evidence of title by which the property is acquired that the property is separate and not community property; or (ii) proof that the spouses have made a written agreement that the property is separate property.

Neither tracing, nor an oral or implied agreement, is sufficient to rebut the general community property presumption.[19]

Example: Mary and George buy a house during marriage and take title as joint tenants. George uses separate property funds to make the down payment on the house. The spouses make no written agreement that each of their joint interests would be separate property. The remaining payments are made with community funds. The spouses then terminate their marriage. On dissolution the house will be presumed to be community property. This presumption cannot be overcome because there is no written agreement that the property will be separate. George, however, is entitled to reimbursement for his separate property down payment provided that he can trace the down payment to his separate property funds.

As elsewhere with the community property presumption, it arises only on divorce, and does not affect the spouses' ability to hold property as joint tenants, and does not affect the ability of a third party creditor in reaching the property.

[16] California Family Code Section 2640.
[17] California Family Code Section 770.
[18] See, Family Code Sections 770, 781, 802 and 803.
[19] However, traceable separate property contributions may be reimbursable.

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What happens when spouses jointly set up a living trust, and one spouse contributes separate property? While trusts usually provide that they do not alter the separate-community nature of the assets, real estate should always be titled to make it clear that it is either community or separate property. Consequently, the following method of titling is recommended: John and Jane Doe, Trustees of the Doe Family Trust dated 1/1/05, as the separate property of Jane Doe.

- **Husband and Wife**

Property titled in the spouses' names as husband and wife creates a community property presumption, unless the instrument indicates otherwise. However, unlike the joint tenancy presumption which is effective only on divorce, the presumption created by the "husband and wife" title is effective both on divorce and against a third party creditor.[20]

- **Property Purchased in Name of Other Spouse**

When a spouse uses either community or his or her separate funds to purchase property in the name of the other spouse alone, there is a presumption, that the purchasing spouse has made a gift of his or her interest (community or separate) to the other spouse.[21] However, the purchasing spouse may attempt to rebut this presumption with evidence that he or she did not intend to make a gift. The rebuttal will be successful if the purchasing spouse establishes (i) the separate nature of the funds used to purchase the property, and (ii) the existence of an understanding between spouses that the property is not a gift.

B. Available Planning Techniques

1. Premarital Agreements

a. Generally

Agreements made in contemplation of marriage between intended spouses and between intended spouses and third parties have been variously described as marriage settlements, marriage contracts, premarital contracts, premarital agreements and antenuptial agreements. For ease of reference, this outline will refer to such agreements as premarital agreements.[22]

Under the Uniform Premarital Agreement Act (adopted by California in 1986), a premarital agreement, to be valid, needs to comply with the following requirements: (i) be in writing; (ii) be signed by both parties; (iii) be voluntarily entered into and not otherwise unconscionable or made without required disclosures of property and financial obligations; and (iv) have a lawful object, which may include any of the following matters: (a) the rights and obligations of each of the parties in any of the property of either or both of them, whenever and wherever acquired or located; (b) the right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property;
(c) the disposition of property on separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event; (d) the making of a will, trust, or other arrangement to carry out provision of the agreement; (e) the

[20] See, Abbett Electric Corp. v. Storek, 22 Cal. App. 4th 1460, 1466-1467 (1994) (designation of parties as joint tenants, in addition to designation as "husband and wife," showed "different intention," in action by third party creditor); Estate of Petersen 28 Cal. App. 4th 1742, 1747 (1994) (when title held as "husband and wife, as joint tenants," joint tenancy form of title rebuts community presumption arising from "husband and wife" title).
[21] See, In re Marriage of Frapwell, 49 Cal. App. 3d 597, 600-601 (1975).
[22] See also, California Family Code Sections 1500 *et. seq.* (general provisions governing marital agreements), and 1600 *et. seq.* (Uniform Premarital Agreement Act).

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ownership rights in and disposition of the death benefit from a life insurance policy; (f) the choice of law governing the construction of the agreement; and (g) any other matter, including the parties' personal rights and obligations, not violating public policy or a statute imposing a criminal penalty.[23]

Under no circumstances may a premarital agreement affect the child support rights of a child.[24]

A premarital agreement may be revoked or amended only by a written agreement.[25]

Spouses often seek to set aside a premarital agreement, or argue that the agreement is not enforceable as to them. Generally, for a spouse to set aside a premarital agreement, the spouse must demonstrate undue influence, usually coupled with misrepresentation.[26]
To determine the existence of undue influence, the courts will usually attempt to ascertain the parties' respective bargaining power. Some of the factors that the courts will consider include: (i) extreme disparities between the parties in age, knowledge, or sophistication;
(ii) substantial differences between the parties in their respective degrees of business expertise; (iii) vulnerability of the party claiming undue influence at the time the agreement was executed due to illness, poverty, pregnancy, or similar circumstances; or
(iv) lack of representation for the party claiming undue influence by independent counsel during the preparation, drafting, and signing of the premarital agreement, especially when the other party was represented.

Previously, premarital agreements that sought to limit spousal support payments on dissolution of marriage were held to be unenforceable, as against public policy (they were sought to promote dissolution of marriage). However, in somewhat recent California Supreme Court case, the Court held that spouses may limit support payments to each other during marriage or on dissolution.[27]

Note: Premarital agreements (as well as the postnuptial agreements discussed below), are legally enforceable documents. That means that in the event of a divorce, the court will respect the division of property agreed to by the spouses in such an agreement. (Thus, the wife may transfer most of her assets to her husband and avoid her creditors, only to find that at some later date her husband files for divorce and gets to keep all assets.)

Consequently, clients must always be warned about this risk when entering into a premarital or a postnuptial agreement. When contemplating entering into such an agreement, specifically a postnuptial agreement, the spouses should carefully consider the strength of their marriage union, and weigh not only the possibility of a divorce, but also the likely division of property on divorce.

b. Use in Asset Protection

As the above summary of the California community property laws suggests, holding assets in a community property form is less desirable than separate property, at least from an asset protection perspective. The reason

[23] Family Code Section 1612(a).
[24] Family Code Section 1612(b).
[25] Family Code Section 1614.
[26] Prior to marriage, the soon to be spouses do not owe each other fiduciary obligations. The fiduciary obligations of fair dealing and good faith arise only on marriage.
[27] In re Marriage of Pendleton & Fireman, 24 Cal. 4th 39 (2000). The waiver will be effective when the parties are "intelligent, well-educated persons, each of whom appears to be self-sufficient in property and earning ability, and both of whom have the advice of counsel regarding their rights and obligations as marital partners at the time they execute the waiver."

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is that all of community property is liable for the debts of either spouse, whether incurred before or during marriage. Contrast that with separate property, which is only liable for the debts of that spouse who owns the separate property (except for obligations with respect to necessities of life).

Clearly, in the context of asset protection planning, one would always want to convert community property to separate. One way of accomplishing that goal is for spouses to transmute their community property into separate. (Transmutation agreements were briefly discussed above, and will be addressed in more detail below.) However, transmutation agreements are subject to the fraudulent transfer laws. In light of that, premarital agreements are a much better way of converting community property into separate.

Example: Fred and Wilma fall in love and decide to get married. Wilma, afraid of losing Fred, forgets to mention to him that she owes a large sum of money to the Bedrock Tax Authority. The couple gets married, and lives off Fred's earnings, Wilma is a housewife. The Bedrock Tax Authority proceeds to collect the tax liability from Wilma. Wilma considers filing an offer in compromise, but realizes that Fred's earnings are sufficient to pay off the liability. Because Bedrock is a community property jurisdiction, Fred's earnings can be used to satisfy Wilma's tax liability. The spouses considered entering into a transmutation agreement, but realized that in light of an existing tax liability, the transmutation agreement would probably be a fraudulent transfer.

Fred and Wilma should have entered into a premarital agreement. Why?

Parties to a premarital agreement are generally permitted under the Uniform Premarital Agreement Act to waive property rights that they might otherwise acquire in the future as a result of marriage.[28]

Additionally, the California Supreme Court has suggested that a premarital agreement providing that the spouses' earnings will be their separate property is valid as against subsequent creditors with a right to community funds, provided that no creditor is misled to his or her detriment by the failure of the spouses to inform the creditor that the supposed community assets on which the creditor relied in extending credit are in fact separate assets.[29] See section C. below about recording premarital agreements.

This means, that if Wilma waived her rights to Fred's earnings by using a premarital agreement, Wilma could have filed an offer in compromise. (Prior to marriage, spouses have no interests in each other's property, and Wilma's waiver of future rights is not a transfer for fraudulent transfer purposes. As there is no transfer, there is no fraudulent transfer.)

A waiver of property rights through a premarital agreement will be enforceable only if the spouses understood the nature of the rights they were waiving. That is why it is usually recommended that a detailed inventory of assets be attached to a premarital agreement.

It is important to note that certain rights cannot be waived through a premarital agreement, because such rights can only be waived by spouses. An example is a joint and survivor annuity under ERISA.

To a certain extent, premarital agreements may be also challenged as violating the fraudulent transfer laws. For example, if the premarital agreement not only addresses the property rights upon marriage, but also transfers the separate property of one spouse to the other spouse, without property consideration, such transfer may be deemed as being fraudulent as to the present creditors of a spouse.

It should be also noted that transfer of separate property through a premarital agreement is subject to the gift tax, as the parties are not yet married at that time.

[28] California Family Code Section 1612.
[29] In re Marriage of Dawley, 17 Cal. 3d 342, 357 (1976).

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c. Recording a Premarital Agreement

Premarital agreements may be executed and acknowledged or proven like a grant of realty and subsequently recorded in each county in which real property affected by the agreement is located; but acknowledgment, proof, and recordation are not required as such for the agreement to be enforceable.[30] Recording or non-recording of a premarital agreement has the same effect as recording or non-recording of a grant of real property.

An unrecorded instrument is valid between the parties and those third parties who have notice of the instrument.[31] Accordingly, an unrecorded premarital agreement is valid as between the spouses. It may also be valid as to third parties who have actual notice of the terms of the agreement. This appears to be the rule, regardless of whether the subject matter of the agreement is real property, personal property, or a combination of the two.

This means that a premarital agreement entered into for asset protection purposes should be recorded to the extent it concerns real property. If the agreement is not recorded, a creditor dealing with one spouse may assume that all of the spouses' property acquired during marriage will be available to satisfy the debt. Consequently, the creditor should be put on notice that this is not the case.

Because spouses usually would not want to disclose to the world all of their financial interests and business dealings, practitioners would often record a document known as a Memorandum of Premarital Agreement. The memorandum is a brief summary of the premarital agreement that does not contain the inventory of spouses' assets, other than real property. The ownership of real property is always a public record.

Some practitioners record the premarital agreement with the full inventory, but deleting the values of the assets. Liabilities never need to be listed.

Even if the creditor was not put on notice as to the fact that there is no community property, or that assets that would ordinarily be community are in fact separate, the creditor can disregard the premarital agreement only if both spouses signed the contract giving rise to the debt. If only one spouse signed, then even if the creditor was not aware of the existence of a premarital agreement, the creditor is precluded from proceeding after the separate property of the non-debtor spouse.

2. Postnuptial and Transmutation Agreements

a. Postnuptial Agreements

An agreement between spouses after the marriage ceremony and affecting the spouses' property rights is referred to as a postnuptial agreement. A transmutation agreement is a postnuptial agreement that changes the character of the spouses' property from community to separate, or vice versa.

Postnuptial agreements are governed primarily by the California Family Code Sections 721, 1500 and 1620. Section 721 provides that postnuptial agreements (as opposed to premarital) are subject to the general rules governing fiduciary relationships that control the actions of person occupying confidential relations with each other.

[30] California Family Code Section 1502.
[31] California Civil Code Section 1217.

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Section 1500 provides general authority for spouses to alter their property rights by a marital property agreement. Section 1620 states that, except as otherwise provided by law, a husband and wife cannot, by a contract with each other, alter their legal relations except as to property.

As discussed below, postnuptial agreements that are transmutation agreements are subject to certain other statutory provisions.

b. Transmutation Agreements

i. Generally

Many postnuptial agreements have as their purpose the change, or transmutation, of the character of the parties' property from separate to community, or vice versa. Spouses are free to alter the character of property in this manner, provided that all statutory requirements are met. A transmutation agreement may be used to change the character of property to be acquired in the future, as well as property that the spouses own at the time of the agreement.[32]

The principal limitation on transmutation agreements between spouses is that (i) they must be fair and based on full disclosure of the pertinent facts, and (ii) they must not be a fraudulent transfer of assets.

The following are the major considerations pertaining to transmutation agreements: (i) except for certain interspousal gifts, transmutations of real or personal property are not valid unless 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; (ii) transmutations may be made with or without consideration; (iii) transmutations of real property are not effective with respect to third parties without notice of the transmutation, unless the transmutation is recorded (see, Recording Premarital Agreements, above); (iv) transmutations are subject to the laws governing fraudulent transfers; and (v) a statement in a will of the character of property is not admissible as evidence of a transmutation of the property in any proceeding commenced before the death of the person who made the will.

ii. Tax Effects

Transmutation agreements have certain tax implications. For income tax purposes, if spouses file a joint return, then characterization of property as community or separate is irrelevant, as all income is aggregated. However, if spouses file a separate return, then each spouse must report his or her one-half share of community income, and his or her separate income. Because transmutation agreements change the nature of the property (including earnings and other income), they have the greatest income tax impact on separate tax returns.

Transfers of property between spouses are generally nonrecognition events for income tax purposes, as they are always considered to be gifts with basis carryover. There are a couple of exceptions: (i) transfer to a spouse who is a nonresident alien at the time of the transfer; (ii) transfer in trust, to the extent that the sum of the liabilities assumed, plus the liabilities to which the property is subject, exceeds the total adjusted basis of the property; or (iii) transfer in trust, of an installment obligation.[33]

The more important tax aspect of a transmutation agreement is the effect that it has on basis step-up (or step-down) at death.

On a spouse's death, one-half of the community property belongs to the surviving spouse, and the other half belongs to the decedent.[34] If the property has appreciated in value during the time that it was held, the entire

[32] California Family Code Sections 850, *et. seq.*
[33] See, Code Section 1041.
[34] California Probate Code Section 100.

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property will receive a stepped-up basis equal to its fair market value on the date of the deceased spouse's death, if the decedent's half of the property was included in his or her estate.[35] The surviving spouse will receive a stepped-up basis in his or her half of the property, and will therefore have a smaller gain on disposition of that property.

By comparison, if the spouses had held the property separately in joint tenancy with a right of survivorship, the surviving spouse would automatically receive his or her half of the property by operation of law through the original joint tenancy title, and not through inheritance or any other type of succession after death. Consequently, his or her basis would not be stepped up if the property has appreciated, but instead would remain at the original cost basis.

Thus, while transmutation agreements are generally desirable from an asset protection standpoint, they may have adverse tax consequences, because of the loss of one-half of basis step up. By carefully coordinating the transmutation agreement with the spouses' will or trust, many of the adverse tax consequences can be minimized or eliminated. For example, if the spouses' residence is the separate property of the surviving spouse, then while the residence will not receive a step-up in basis, up to $250,000 of gain will be sheltered on the sale of the residence.

It is important to remember that the loss of the basis-step up on one-half of property is important only if it is anticipated that the surviving spouse will be selling his or her separate property. Thus, if the surviving spouse retains her separate assets and sells the property inherited from the decedent (which received a basis step up), no adverse tax consequences will result.

The practitioner should also keep in mind that spouses may enter into a transmutation agreement at any time, during marriage. Accordingly, while the spouses are working or practicing their profession (and they are exposed to risks) they can enter into a transmutation agreement and transfer certain assets to the low-risk spouse. When the spouses retire and risks dissipate, the spouses can enter into another transmutation agreement and convert their separate property back to community, regaining the full step up.

While postnuptial agreements are generally subject to the same notice and recording rules as premarital agreements, the rules for transmutation agreements are slightly different.

A transmutation of real property is not effective with respect to third parties who are without notice of the transmutation unless the transmutation instrument is recorded.[36] While recording is not a prerequisite to the validity of the transmutation as between the spouses, it is a prerequisite in making the transmutation effective with respect to third parties who are otherwise without notice. This requirement is consistent with the fact that transmutations are subject to the laws governing fraudulent transfers.

iii. Structuring the Transmutation Agreement

When clients are first apprised of the uses of transmutation agreements their first impulse is to transfer all the assets to the low-risk spouse. While this impulse is logical, transmutation agreements are subject to fraudulent transfer laws. This means that when assets are divided between spouses pursuant to a transmutation agreement, the division should be on a somewhat equal basis. Approximately 50% of net fair market value of the assets should go to each spouse.

[35] Code Section 1014(b)(6).
[36] California Family Code Section 852(b).

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While this practice minimizes the fraudulent transfer likelihood, now only 50% of the assets are protected, and not 100%. However, the usability of the transmutation agreement can be buttressed by allocating "desirable" assets to the low-risk spouse and the "undesirable" assets to the high-risk spouse. In this context, desirable and undesirable is evaluated from a creditor's point of view.

Example: Mrs. Curie is a physics professor at Cal Tech, and Mr. Curie is a plastic surgeon. Mr. Curie gets sued by patients on a bi-weekly basis (he is the high-risk spouse) and Mrs. Curie has never been sued and will probably never get sued (she is the low-risk spouse). The assets of the two spouses are: the medical practice valued at $1 million and a house valued at $1 million. How should the transmutation agreement divide these assets?

The transmutation agreement should make the medical practice the separate asset of the husband and the house the separate asset of the wife. From a creditor's standpoint, the house is a desirable asset (easy to collect against), and the medical practice is an undesirable asset (no value to the creditor other than receivables). Consequently, while the allocation is on a 50-50 basis (each spouse gets an equivalent amount of assets), the asset that is easy to collect against has been moved to the low-risk spouse (where the asset is unreachable by the creditor of the high-risk spouse).

Accordingly, when Mr. Curie is sued again by one of his patients, the patient can collect only against the medical practice, and not against the house.

3. Divorce

a. Common Law States

For spouses planning a divorce, the timing of the divorce can be an effective asset protection tool.

In common-law jurisdictions, a creditor can proceed only after the debtor spouse, and only if the debtor spouse has property vested in his or her name. This means that if pursuant to the divorce the debtor spouse will vest in certain assets, divorce should be postponed, if possible. As soon as the assets are vested in the name of the debtor spouse, the creditors of the debtor spouse will be able to reach such assets.

By the same logic, if the debtor spouse is currently vested in certain assets that are desired by the creditor and divorce would vest such assets in the nondebtor spouse, divorce should be accelerated. Pursuant to the divorce the assets will be transferred from the debtor spouse to the nondebtor spouse, and thus outside of the reach of creditors.

In most common law jurisdictions, marital property is divided equitably on divorce, but not necessarily equally. "Equitably" means that the court is allowed to take a host of factors into account in allocating property between the spouses, such as the respective incomes, ages, health and future income potential of the two spouses. This means that if the two spouses are planning to divorce while minimizing their exposure to creditors of either spouse, the spouses should consider both the timing of the divorce and the division of property on divorce. While the division of property should always be undertaken at arm's-length, certain amount of flexibility is allowed to make the division "equitable."

b. Community Property States

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In most community property states, the general rule is that community property can be seized to satisfy community debts even after a divorce. This means that once the community incurred a debt, both spouses are liable for that debt, even following a divorce, and even if the liability has been allocated entirely to only one spouse.[37]

However, in California, this rule has been changed so that community property awarded to a nondebtor spouse as separate property is protected from the claims of his or her ex-spouse's creditors, even if the debts are community debts. This means that a community debt, which is generally an obligation of both spouses, can be assigned to only one spouse, in California.[38]

With respect to the separate property of spouses following a divorce, the allocation and division of liabilities on divorce in California are as follows:[39]

> 1. Separate property owned by a married person and property received by that person pursuant to the division of property is liable for debts incurred by the person before or during marriage whether the debt is assigned for payment by that person or that person's spouse.
>
> 2. Separate property owned by a married person at the time of the division and other property received by that person is not liable for debts incurred by the person's spouse before or during marriage and the person is not liable for such debt unless it was assigned to him or her in the division of property.
>
> 3. Separate property and other property received by a married person is liable for debts incurred by the person's spouse before or during marriage and the person is personally liable for the debt if it was assigned for payment by the person pursuant to the division of property.

While a community debt can be assigned to only one spouse (in California), that does not mean that the spouses can assign all of the liabilities to one spouse, and all of the assets to the other spouse. Transfers of property pursuant to a divorce, like any other transfers of property, are subject to the fraudulent transfer laws.

For example, in Britt v. Damson,[40] the spouses divorced and the husband filed for bankruptcy. There was a claim that the property transferred to the wife pursuant to the divorce was fraudulent. The court held that although the division of property was not fraudulent under state law, it could be under the Bankruptcy Code's fraudulent conveyance provisions. The court stated:

> To the extent that the value of the community property ordered to [the wife] was offset by the value of the community property awarded to husband, the 'transfer' to [the wife] was, as a matter of law, supported by 'fair consideration,' …
>
> To the extent that the award of community property to [the wife] may have exceeded half of the total value of the community property, there is a question whether, under all the circumstances, [the husband] received fair consideration as a matter of law.

The Ninth Circuit thus made it apparent that even on divorce, transfers of property can be scrutinized and tested under the fraudulent transfer laws.

[37] Wikes v. Smith, 465 F. 2d 1142, 1146 (9th Cir. 1972).
[38] California Family Code Section 2551.
[39] California Family Code Section 916(a).
[40] Britt v. Damson, 334 F. 2d 896, 902 (9th Cir. 1964), cert. denied, 379 U. S. 966 (1965) .

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In a more recent case, the California Supreme Court attempted to harmonize California Family Code Section 2551 and the UFTA.[41] As discussed above, Section 2551 provides that the property received by a person on divorce is not liable for debt incurred by the person's spouse before or during marriage, and the person is not personally liable for the debt, unless the debt was assigned pursuant to the divorce to that person. This means that in California divorce overrides the asset protection disadvantages of the community property system.

In contrast to Section 2551 is the UFTA which provides that any transfer of property is subject to the laws of fraudulent conveyances.

The California Supreme Court reasoned that the California Legislature has a general policy of protecting creditors from fraudulent transfers, including transfers between spouses. Just as the fraudulent transfer laws apply to transmutation agreements during marriage, so do those laws apply to transfers of property on divorce.

Despite the court's holding the transfers of property on divorce are subject to the UFTA, challenges under the UFTA are still limited in the context of divorce and leave room for planning opportunities. Under the UFTA, a creditor can allege that the transfer was either actually or constructively fraudulent.

Constructive fraud requires little more than a finding that one of the spouses was left insolvent – a straight forward and objective analysis. However, actual fraud requires a subjective analysis which makes it more difficult for a creditor to prevail in the context of divorce. Courts are most reluctant to delve into the inner thoughts of spouses in an attempt to discern the intentions behind a divorce.

[41] Mejia v. Reed, 31 Cal. 4th 657 (2003).

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