

CHARACTER OF MARITAL PROPERTY

Marital property is the property that a spouse owns during or at the end of a marriage. Texas characterizes marital property owned by a couple as either community property or separate property. Determining the character of marital property can be extremely complex. This discussion is intended only to give you an overview of the basics of this analysis.

The character of property held by a couple is important in three areas: divorce, creditor protection and estate planning. We tend to think of the character of property as being relevant only in the event of a divorce. Frequently, we do not consider its importance in the event of our deaths.

We can dispose of all of our separate property and our half of the community. This one determination can significantly affect the disposition of our property upon our death. Any area which has this impact on the disposition of our property also affects the probability of conflict among ones heirs upon ones death. Let's look at a simple example. Let's say that Ben and Kate have been married for 15

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years. Their marriage is the second marriage for each of them and each of them have children of prior marriages. Ben had approximately \$500,000 in assets at the time they were married. The couple has a total estate of \$2 million. Ben and Kate did not have a premarital agreement. Ben's Will leaves all of his property in trust with the income paid to Kate for her lifetime. No principal

may be distributed from the trust. Upon Kate's death, the property passes to Ben's children. If Kate does not survive Ben, then all of his estate passes to his children. Kate's Will is structured in the same manner naming her children only. If all of the property is Ben's separate property (e.g., reinvestment and growth of his original \$500,000), then \$2 million is held in trust for Kate and upon her death, the property passes to Ben's children. If the \$2 million is community, \$1 million is

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held in trust for Kate (with the property passing to Ben's children upon Kate's death) with the remaining \$1 million held by Kate outside of any trust and, therefore, will pass under her Will to her children. By simply proving that the entire \$2 million is separate, Ben's children can double their inheritance and eliminate any inheritance by Kate's children.

The character of your property is important. Let's look at some of the basic rules in determining the character of marital property.

All marital property is presumed to be community property. Therefore, unless clear and convincing evidence is presented to the contrary, the marital property is community property. Separate property is

- ▶ all property which is owned prior to marriage, and
- ▶ all property which is inherited or received as a gift during marriage.

Income on separate property is community property.

All other property is community property. So what does all this mean? Let's look at some results of these rules.

- ▶ Income on separate property is community property.
- ▶ Earnings are community property.
- ▶ If separate property and community property are mixed together (commingled), then all property becomes community property.

Does that mean if you deposit one check received as an inheritance in your joint account, "poof" it's community. Not necessarily. You may be able to prove that the property is your separate property. This proof process is generally referred to as "tracing" your separate property. Let's assume you want to prove that 100 shares of IBM stock is your separate property. You did not own the IBM stock when you got married. You did not inherit the stock during your marriage. You bought the stock with the proceeds from the sale of Exxon stock. You owned the Exxon stock prior to your marriage. Separate property can be

traced if you can show that the property was exchanged for other separate property or was purchased with separate property. In my example, the Exxon stock was separate. The proceeds from the sale of the stock would therefore be separate. The IBM stock would have been purchased with separate property. A couple of the rules used to trace separate property are:

- ▶ If separate property is deposited in a bank account and, immediately thereafter, a check is written for approximately the same amount, the check is presumed to be separate property.
- ▶ If community and separate funds are both held in a bank account, it is presumed that the community is spent first.

What if you own property prior to marriage so it is clearly separate, for example, a home, but you use your earnings to pay the mortgage and make improvements on the property? Does the home become community? No, but your

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community estate does acquire an equitable interest in the home. Until recently the law allowed the community to be reimbursed in an amount which was basically the amount by which the principal of the mortgage was reduced and the amount by which the value of the house was increased by the improvements. However, a recent change in the law actually provides the community with an equitable interest in the home and not just a right to reimbursement.

Another asset which many couples own is a retirement account. Under the current law of the State of Texas, the value of the retirement account on the date of the marriage is separate. All increases in value in the retirement account from that date are community.

Tracing is a mess. It is tedious, expensive and time-consuming... just for starters. Yet, as was illustrated in the above example, the character of property can have a significant impact on the disposition of property.

So what can you do? First of all, clarity is important. Do you know what the character of your property is?

1. Make a list of all of your property.
2. Divide the list into two categories: separate property and community property.
3. The separate property category should include only property which has no possible question as to the character. The property is the identical property owned at the time of your marriage. None of the income from the property has been commingled with the separate property.
4. Write down how the property is distributed under your Will and estate plan and determine if the property is flowing to whom you want and in the manner in which you want.

Your property will include all of your separate property and one-half of your community property.

Keep in mind if you name a beneficiary on a retirement account, life insurance policy or annuity or hold property as joint

tenants with right of survivorship, the property does not pass under your Will. The property in these accounts passes as set forth on the beneficiary designation or the survivorship designation.

This process may lead to a very different result than you would have anticipated. If so, it is likely to be a different distribution than your family anticipated as well. This situation is likely to cause conflict.

Is there anything you can do about it? First, the purpose of this process is to

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make you aware of the effect on your estate plan of the character of your property. The purpose is not to change the character of your property. You can change community property to separate property. The decision to change the character of property is not one to be made casually. As mentioned above, the character of property significantly affects the rights of the spouses upon divorce as well as on death. Each spouse should be represented by his/her own attorney if an agreement is entered into which affects the character of marital property.

Let's assume that you and your spouse agree on the character of your property. If you agree on the character of your property, an agreement acknowledging

Changing community property to separate property can be done.

the character of your property can be helpful in avoiding conflict among your heirs over the character of the property. This type of agreement does not change the true character of the property.

What if you and your spouse agree that certain property is separate but the property is, in fact, community. The issue of the character of your property can still arise. Changing community property to separate property can be done. You can agree that certain property is separate. The couple actually divides (technically, you partition) any community property into two parts with each spouse owning a part of the property as his/her separate property. Then one of the spouses can give his/her part of the property to the other spouse by gift. You and your spouse have just created separate property out of community. The income from this separate property would also be the separate property of the receiving spouse because of a recent amendment to the Texas Constitution. The income from the gift property would be separate but the income from the partitioned property would not be separate.

Until recently you could not convert separate property into community property. You might be thinking "why would I ever want to," since owning the property 50/50 as each spouse's separate property is essentially the same thing.

You cannot make separate property into community property.

For purposes of determining which property passes under the deceased spouse's Will, this assumption is correct. However, community property has a very favorable tax treatment on death. When a person dies, all of his/her property receives a new basis equal to the value of the property at the time of death. This adjustment to the basis of property is commonly referred to as a *step up in basis* even though the adjustment can result in a reduction in basis.

To illustrate the benefits of the basis adjustment, let's assume that you purchased property for \$10 and it's now worth \$100. If you sell the property, you will recognize a \$90 capital gain. If you hold the property until your death, your heirs will have a new basis of \$100. If your heirs sell your property after your death for \$100, no gain will be recognized since their basis will be equal to the sales price. Texas laws now allow separate property to be "transmuted" into community property. So, you can partition community property so that the property is owned one-half by each spouse as separate property, and you can convert separate property into community property.

If you have not had legal advice during your marriage in order to keep your

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separate and community property separated, you probably have more community property than you realize. If there is any uncertainty as to the character of the property, you should consult an attorney.

Now, let's say that there is uncertainty about the character of your property but you and your spouse agree as to the character of the property and want to clarify the character of your property. The clarification may be possible.

What do you do if you have both separate and community property and you cannot agree on the character of the property? Is this an area where you say - this is too difficult, too tense, so let's forget it. If you have only been married once and both of you are leaving all of your property to your children --- and you are not concerned

about the survivor remarrying or having a change of heart maybe so?

As you can guess, my response is a resounding "NO." You may agree to disagree and determine how you will have

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your property pass upon your deaths. Even in one marriage situations in which all of your children were born to or adopted during this marriage, problems can occur. When you add in second marriages, his/hers/ours children, the problems increase exponentially. Since the ways in which this issue is addressed are as varied as the individuals who are in this situation, I cannot give you a short answer.

Sometimes, the response may include giving each of you the use of certain property after one of your deaths and agreeing that the property pass to certain children or other individuals on both of your deaths. It may include making certain bequests of property assuming that the survivor did not challenge the character of the property.