Price & Farrington's Estate and Tax Planning *Fast* Faxts

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Estate, Tax and Wealth Planning for Advisors and Clients

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Community Property 101:
A Refresher for Advisors and Clients

Let's bone up on an important and often murky area of estate planning for many of you and your clients.

If you're married and living in Washington State, you're subject to Washington's community property laws. The character of property as *community* or *separate* depends on when and how it was acquired. *Caution*: contrary to popular belief, how the property is registered or titled makes very little difference.

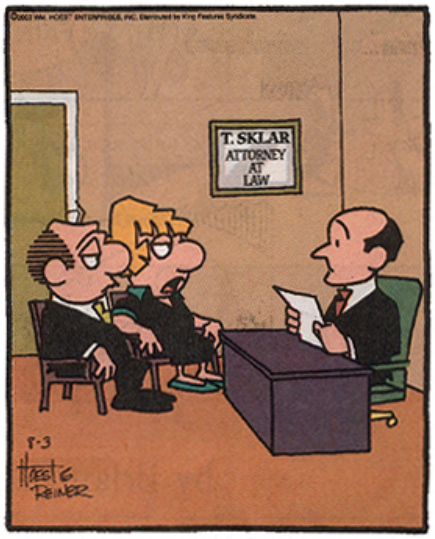
Community and Separate. The community property laws of Washington spring from a public policy in this state to have both H and W share equally in the fruits of either spouse's property rights during marriage. The general rule is that all property acquired by either spouse during marriage is community property. As such, the property is owned by both spouses equally. Separate property is any property that is: (1) owned before marriage; (2) received during marriage as a gift or inheritance; or (3) generated by separate property (e. g., rent from a separate property rental house). Separate property belongs to the spouse who owned or received it.

What if mixed funds are used to acquire property? Special rules determine the character of property purchased over time (e.g., on an installment contract). It is usually determined by the character of the down payment – if any – and the credit pledged. Example: H and W buy a $10,000 car by paying $2000 down from an inheritance W received (her separate property). H and W pledge their community credit for the balance (both sign for the loan). The car will be 20% W's separate property (2/10) and 80% community property (8/10). *The character of the funds actually used to pay for the car (after the down payment) makes no difference.* The ownership's character will remain the same even if H uses property he owned before marriage or received as an inheritance (his separate property) to pay off the loan However, he will be entitled to reimbursement for those payments.

The life insurance exception. Proceeds of a life insurance policy have the same character as premiums actually paid. Example: If half of the premiums are paid with community funds after marriage, the policy proceeds will be 1/2 separate and 1/2 community. *But,* term insurance takes the character of the premium payment for the most recent coverage period (because there is no benefit to term insurance other than pure protection which must be paid for as each premium comes due or the policy lapses).

Changing the Character of Property. Separate or community property can be changed – either intentionally or unintentionally.

Intentional Changes. A written "contract" between a husband and wife — called a "community property agreement"— can change separate into community property (including property that is acquired later, e.g., by inheritance), and can cause the community property to pass automatically to the surviving spouse at time of death, without need for probate.



"I'M LEAVING EVERYTHING TO LEROY AND HE'S LEAVING EVERYTHING TO ME, WHICH MEANS NEITHER OF US GETS ANYTHING."

A "separate property (or "status of property") agreement" can convert community to separate property. Example: H and W agree that all funds in a specified bank account will be characterized as W's separate property regardless of the source of the deposits.

These agreements must be in writing, signed by both spouses and notarized.

Pre– and Post-Nups. Another type of separate property agreement is the premarital (prenuptial) agreement. H and W can agree in writing that property that would otherwise be community will be one spouse's separate property. They can also identify existing separate property and agree that it will remain separate throughout the marriage – a common tactic where one party brings disproportionately large wealth to the marriage. Courts impose certain requirements on prenups before they will be enforced, including that the agreement be fair, that all assets must be

For more insights into tax and IRA planning with community property, including several planning examples, contact us for a copy of our **February, 2002 FastFaxts**: ***"Smart Tax Planning in Community Property States: Proceed with Caution".*** *We'll be happy to fax or e-mail it to you.*

fully disclosed and that both parties are represented by independent counsel. A word to the wise: consult an attorney to be sure that the agreement is properly prepared; The stakes are too high to do otherwise. (See our July, 2003 *Fast*-Faxts: "Prenuptial Pitfalls".)

Unintentional Changes. Beware: the character of property can change if it is commingled with community property. Example: separate funds are deposited in a bank account that holds community funds. With only limited exceptions, *once the funds are commingled, the entire account will be treated as community property*. Warning: All separate assets must be segregated in order to preserve their separate character.

Managing and Disposing of Community and Separate Property. Generally, both H and W have equal rights to control and manage the community property. While this typically allows either one acting alone to buy, sell and deal with community property, the following transactions require both spouses to act together:

☑ Selling, buying, or encumbering community real property;

☑ Selling or encumbering household furnishings or appliances;

☑ Selling, buying or encumbering assets of a jointly managed community business; and

☑ Making a gift of community property.

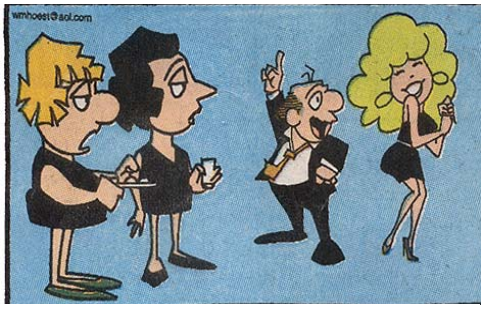
Separate property belongs only to the spouse who owns it. As a result, only that spouse has the right to manage, buy, sell, encumber, or otherwise transfer his or her separate property.

When H or W Dies. On death, each spouse can dispose of 1/2 of the community property by will or will substitute, such as a living trust. Here's an important, and often misunderstood, fact: *The surviving spouse need not receive the deceased spouse's share*. H or W may leave their community property to a child, friend, charity, the milkman or their favorite estate planning attorney.Each spouse also has the power to dispose of his or her separate property. If the deceased spouse has no will, his or her community property will pass to the surviving spouse under the laws of intestacy. The deceased spouse's separate property, however, may pass in part to relatives other than the surviving spouse unless there is a will that provides for a different plan.

Creditors. Generally, a creditor will only be able to reach property that has the same character as the debt owed by the spouse. Any debt incurred by a spouse before marriage is that spouse's separate obligation. This means that those creditors will normally only be able to reach that spouse's separate property, and not community property, following the marriage. Here are the most notable exceptions to that rule:

☑ Alimony and child support payments, which are enforceable against the debtor spouse's wages (community property) during the second marriage; and

☑ Debts that are reduced to judgment within three years of marriage and are enforceable against the "earnings and accumulations" of the debtor spouse.



"That's my husband Leroy, also known as the marriage penalty".

Quasi-Community Property. If during your marriage you've moved from another state or country that doesn't have community property, your will or living trust could be affected byWashington's quasi-community property law. Quasi-community property is the separate property of a deceased spouse that *would have been community property* if it had been acquired by the spouse while living in Washington. It might be advisable to prepare an agreement overriding those rights. The quasi-community property law has many exceptions and special rules. We strongly recommend that you consult a qualified estate planning attorney about the impact of quasi-community property upon your estate plan.

Disclaimer. This month's *Fast*Faxts covers a broad overview of the general rules of community property, but there are many exceptions to those rules that must be considered before you make decisions that affect your estate planning and your rights. Planning with *or around* community property laws is not a do-it-yourself activity; the stakes are too high. Protect yourself and enhance your planning by consulting a qualified estate planning attorney. ■

Glenn D. Pierce

Asset Protection and Community Property

In community property (CP) states each spouse's interest in the CP is subject to the claims of the other spouse's creditors. If there is a judgment against H, *all* CP assets held by H and W are available to satisfy the judgment On the other hand, separate porperty (SP) of a spouse will generally *not* be subject to the claims of the other spouse's creditors. Community liability results if (1) the marriage is not defunct, and (2) the acting spouse is either managing CP or is acting for the benefit of the community, or the community in fact benefits from the act. If a spouse engaged in managing CP commits a tortious act, there is *both* separate liability of the acting spouse and community liability. A tort committed in the course of the acting spouse's employment creates a community liability. Because the earnings from employment are CP, it is reasoned that the spouse is acting for the benefit of the community during employment. Community lliability can also result from the torts of an unemancipated child. Recreational activity may also result in community liability because such activities "promote the general welfare of the community". ▫

For eye-opening real-life case studies, look for a future FastFaxts.