

[This article was presented to a group of CPAs and was intended to provide them with some of the basic rules of community property that accountants often overlook]

## **COMMUNITY PROPERTY FOR CPAs**

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Jerry Frank Jones

### A PAGE OF GENERAL RULES ABOUT COMMUNITY PROPERTY

1. All assets acquired before the marriage or during the marriage by gift, devise or bequest are separate property.
2. Everything else is community.
3. But: Upon dissolution of the marriage all assets are presumed to be community.
4. To overcome that presumption: You must prove by clear and convincing evidence that it is separate.
5. Increases in the value of separate property are separate
6. Income from separate property is community.
7. Except,
  - a. The income from a gift from one spouse to the other is presumed to be separate
  - b. Oil royalties and bonus payments (but not delay rentals) are separate.
8. Texans can have community property with right of survivorship.
9. Texans can, as of January 1, 2000, turn separate property into community property by agreement.
10. There is no such thing as a gift to the community.
11. Traceable mutations are separate.
12. Spouses can agree that almost anything is, or will be, separate.
13. Inception of title is paramount.
14. However, how title is taken is not indicative of separate nature.
15. But there is a presumption of separate when
  - a. One spouse is the grantor and the other is the grantee, or
  - b. One spouse provides separate consideration and title is taken in the name of the other spouse, or
  - c. The conveyance document contains a "separate property recital."
16. On divorce, the Court awards the community property as is "just and right."
17. At death, it is 50/50: There is no just and right.
18. Courts cannot award one spouse's separate to the other on divorce.
19. If spouses file separate returns, each spouse must report ½ of each item of community income and ½ of each community deduction of their return.
20. On the death of one spouse, both halves of the community assets get a step up in basis to date of death value.
21. All gifts of community are, for tax purposes, ½ from each spouse (Chase Manhattan vs. Commissioner)
22. But the managing spouse can make a gift without the consent of the other spouse.
23. The non consenting spouse has a remedy only if the gift is a fraud on the community.

**NEW Family Code § 4.201 (HB734): Family Harmony Bill (aka “The Bill Formerly Known as the Transmutation Bill”).** At the November election, the voters passed the Constitutional Amendment to allow Texans to change separate property to community by agreement.

1. All other community property states can already do this. Previously separate property could only be converted to community by co-mingling.
2. Texans may want to do this for a variety of reasons including
  - a. Maximizing Use of the Unified Credit. If the non wealthy spouse dies first, his or her unified credit is lost.
  - b. Maximizing Step up in Basis. If separate property is converted to community, both halves enjoy a step up in basis on the death of the first spouse. This allows the property to be sold with little or no capital gains tax or gifted with a greater basis.
  - c. Avoids Tracing. In many harmonious families, tracing of separate property is an unnecessary expense. Conversion to community can eliminate that process.
3. There was opposition to this bill, primarily from Family lawyers. There was concern that people would convert their separate property to community and have regrets upon divorce. That is a legitimate concern and one that needs to be carefully considered before entering into any such arrangement. However, converting to community is much less draconian than the existing alternative: A gift of separate property to the other spouse. That makes it the separate property of the other spouse: Separate property which is not available to the divorce court when trying to make a fair and just division. The donor spouse has no chance of recovering it on divorce
4. Conversion to community is not as final as partitions and exchanges of community into separate.
5. There was also concern that any conversion to community property exposed the property to an increased range of debts. However, if the property is maintained as the sole management community of the contributing spouse, the increase in range of liabilities is limited to tort claims.
6. This is effective for agreements entered into on or after January 1, 2000.

**NEW Family Code §§ 3.006, 3.401–3.406 & 7.002 (HB 734) Enhancement from Financial Contributions.:** The past legislature also codified the rules of reimbursement upon dissolution of a marriage when one estate makes financial contributions to another (community cash in used to build an apartment house on husband’s separate property lots).

1. The statute is phrased in terms of the community estate making contributions to separate property. However, in § 3.404 the same principals are extended to all contributions between the various estates: His separate, her separate, their community.
2. This statute applies to financial contributions or debt retirement.
3. It does not apply to the measure of reimbursement for community time, toil and labor contributed to separate property. As a result Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984) still controls.
4. The bill says that enhancement in value as a result of community financial contributions

creates “an equitable interest of the community in the separate property.” However, it clearly states that such “equitable interest” does not create an ownership interest but rather gives rise to a “claim...which matures on the termination of the marriage.

5. The section on debt retirement actually provides a formula. There is no formula for straight financial contributions. How that formula works, or better said, how it will be applied and how it is ultimately construed, may be the biggest change.
6. The formula says the “equitable interest is calculated by multiplying the “net enhanced value” (not defined) by the “sum (sic) created by dividing
  - “(1) the total amount of the payments made by the community estate to reduce the principal of the debt on the separate property; by
  - “(2) the sum of
    - “(A) the amount computed under Subdivision (1);
    - “(B) the total amount of the payments made by the separate estate to reduce the principal on the debt; and,
    - “(C) the total amount of any additional amount spent by the separate estate to acquire the interest in the property.”
7. It applies these principals to all contributions between estates (his separate, her separate, their community).
8. It authorizes a court to impose an equitable lien. Unfortunately, it says a court “shall impose an equitable lien...” Hopefully that mandatory language will not create any unanticipated mischief.
9. The amendment affirms the inception of title doctrine.
10. Finally, it eliminates offsets for “use and enjoyment during the marriage.” For example there shall be no offset for living in the home. However, it is not clear if it also applies to income generated by the property. It is assumed that this language was carefully selected and used to deal with the frequent problem of the courts holding that living in the house is an offset.
11. Except for the precise formula and the offset issue, this statute purports to be a codification of existing law, especially see Anderson v. Gilliland, 684 S.W.2d 673 (Tex. 1985) and Penick v. Penick, 763 S.W.2d 194 (Tex. 1988)..
12. The amendment says it is effective September 1, 1999. Then it goes on to say it applies to suits for dissolution pending on September 1, 1999 or filed on or after that date.

**TEXAS CONSTITUTION**, Article XVI, Sec. 15. All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or

descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud pre-existing creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses also may from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; ~~and~~ spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property.

## NEW FAMILY CODE SECTIONS

Sec. 3.006. PROPORTIONAL OWNERSHIP OF PROPERTY BY MARITAL ESTATES. (a) If the community estate of the spouses and the separate estate of a spouse have an ownership interest in property, the respective ownership interests of the marital estates are determined by the rule of inception of title.

(b) An equitable interest created by Subchapter E:

(1) does not create an ownership interest in a spouse's separate property; and

(2) creates a claim against the spouse who owns the property that matures on termination of the marriage.

Sec. 3.401. ENHANCEMENT IN VALUE DUE TO FINANCIAL CONTRIBUTION OF COMMUNITY PROPERTY. (a) The enhancement in value during a marriage of separate property owned by a spouse due to a financial contribution made with community property creates an equitable interest of the community estate in the separate property.

(b) The equitable interest created under this section is measured by the net amount of the enhancement in value of the separate property during the marriage due to the financial contribution made with community property.

Sec. 3.402. USE OF COMMUNITY PROPERTY TO DISCHARGE DEBT ON SEPARATE PROPERTY. (a) The use of community property to discharge all or part of a debt on separate property owned by a spouse during a marriage creates an equitable interest of the community estate in the separate property.

(b) The equitable interest created under Subsection (a) in the enhanced value of separate property due to financial contributions made with community property is computed by multiplying the net enhanced value of the separate property by the sum created by dividing:

(1) the total amount of the payments made by the community estate to reduce the principal of the debt on the separate property; by

(2) the sum of:

(A) the amount computed under Subdivision (1);

(B) the total amount of the payments made by the separate estate to reduce the principal on the debt; and

(C) the total amount of any additional amount spent by the separate estate to acquire the interest in the property.

(c) For purposes of this section, the cost of any improvements made to the separate property paid for by either the separate or community estate is included as part of the principal of the debt.

Sec. 3.403. APPLICATION OF INCEPTION OF TITLE RULE. (a) This subchapter does not affect the rule of inception of title under which the character of property is determined at the time the right to the property is acquired.

(b) The equitable interest created under this subchapter does not create an ownership interest in property.

Sec. 3.404. EQUITABLE INTEREST OF SEPARATE PROPERTY ESTATE. (a) The separate estate of a spouse has an equitable interest in the enhanced value of the separate estate of the other spouse or in the enhanced value of the community estate for:

(1) a financial contribution made to the other separate estate or to the community

estate; and

(2) the discharge of all or part of a debt of the other separate estate or of the community estate.

(b) The equitable interest created by this section is measured in the manner provided by Section 3.401(b) or 3.402(b), as appropriate.

Sec. 3.405. USE AND ENJOYMENT OF PROPERTY. The use and enjoyment of property during a marriage does not create a claim of offsetting benefits to the equitable interest created by this subchapter.

Sec. 3.406. EQUITABLE LIEN. On termination of a marriage, the court shall impose an equitable lien on community or separate property to secure a claim arising by reason of an equitable interest as provided by this subchapter.

Sec. 4.201. DEFINITION. In this subchapter, "property" has the meaning assigned by Section 4.001.

Sec. 4.202. AGREEMENT TO CONVERT TO COMMUNITY PROPERTY. At any time, spouses may agree that all or part of the separate property owned by either or both spouses is converted to community property.

Sec. 4.203. FORMALITIES OF AGREEMENT. (a) An agreement to convert separate property to community property:

(1) must be in writing and:

(A) be signed by the spouses;

(B) identify the property being converted; and

(C) specify that the property is being converted to the spouses'

community property; and

(2) is enforceable without consideration.

(b) The mere transfer of a spouse's separate property to the name of the other spouse or to the name of both spouses is not sufficient to convert the property to community property under this subchapter.

Sec. 4.204. MANAGEMENT OF CONVERTED PROPERTY. Except as specified in the agreement to convert the property and as provided by Subchapter B, Chapter 3, and other law, property converted to community property under this subchapter is subject to:

(1) the sole management, control, and disposition of the spouse in whose name the property is held;

(2) the sole management, control, and disposition of the spouse who transferred the property if the property is not subject to evidence of ownership;

(3) the joint management, control, and disposition of the spouses if the property is held in the name of both spouses; or

(4) the joint management, control, and disposition of the spouses if the property is not subject to evidence of ownership and was owned by both spouses before the property was converted to community property.

Sec. 4.205. ENFORCEMENT. (a) An agreement to convert property to community property under this subchapter is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not:

(1) execute the agreement voluntarily; or

(2) receive a fair and reasonable disclosure of the legal effect of converting the

property to community property.

(b) An agreement that contains the following statement, or substantially similar words, prominently displayed in bold-faced type, capital letters, or underlined, is rebuttably presumed to provide a fair and reasonable disclosure of the legal effect of converting property to community property:

"This instrument changes separate property to community property. This may have adverse consequences during marriage and on termination of the marriage by death or divorce. For example:

"Exposure to creditors. If you sign this agreement, all or part of the separate property being converted to community property may become subject to the liabilities of your spouse. If you do not sign this agreement, your separate property is generally not subject to the liabilities of your spouse unless you are personally liable under another rule of law.

"Loss of management rights. If you sign this agreement, all or part of the separate property being converted to community property may become subject to either the joint management, control, and disposition of you and your spouse or the sole management, control, and disposition of your spouse alone. In that event, you will lose your management rights over the property. If you do not sign this agreement, you will generally retain those rights.

"Loss of property ownership. If you sign this agreement and your marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of your spouse or your spouse's heirs. If you do not sign this agreement, you generally cannot be deprived of ownership of your separate property on termination of your marriage, whether by death or divorce."

Sec. 4.206. RIGHTS OF CREDITORS; RECORDING. (a) A conversion of separate property to community property does not affect the rights of a preexisting creditor of the spouse whose separate property is being converted.

(b) A conversion of separate property to community property may be recorded in the deed records of the county in which a spouse resides and of the county in which any real property is located.

(c) A conversion of real property from separate property to community property is constructive notice to a good faith purchaser for value or a creditor without actual notice only if the agreement to convert the property is acknowledged and recorded in the deed records of the county in which the real property is located.

Sec. 7.002. DIVISION OF PROPERTY UNDER SPECIAL CIRCUMSTANCES. In addition to the division of the estate of the parties required by Section 7.001, in a decree of divorce or annulment the court shall order a division of the following real and personal property, wherever situated, in a manner that the court deems just and right, having due regard for the rights of each party and any children of the marriage:

(1) property that was acquired by either spouse while domiciled in another state and that would have been community property if the spouse who acquired the property had been domiciled in this state at the time of the acquisition; [ø]

(2) property that was acquired by either spouse in exchange for real or personal property and that would have been community property if the spouse who acquired the property so exchanged had been domiciled in this state at the time of its acquisition; or

(3) the equitable interest, as provided by Subchapter E, Chapter 3, of the:

(A) community estate in the separate estate of a spouse;

(B) separate property of a spouse in the separate property of the other

spouse; and

(C) separate estate of a spouse in the community estate.

(b) The change in law made by this Act by the addition of Subchapter C, Chapter 4, Family Code, takes effect January 1, 2000, but only if the constitutional amendment proposed by the 76th Legislature, Regular Session, 1999, relating to the conversion of separate property to community property, is approved by the voters. If the proposed constitutional amendment is not approved by the voters, that subchapter does not take effect.

(c) The change in law made by this Act by the enactment of Section 3.006, Family Code, and Subchapter E, Chapter 3, Family Code, and by the amendment of Section 7.002, Family Code, applies to a suit for dissolution of a marriage pending on September 1, 1999, or filed on or after that date.

**TEXAS CONSTITUTION**, Article XVI, Sec. 15. All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud pre-existing creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses also may from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; ~~and~~ spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property.