How Transmutation to Community Property Can Save Hundreds of Thousands for Married Couples (and Domestic Partners too)

October 2015

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If legal marriage is new to you, and if you and your spouse have property from before the marriage, you may want to ask your estate planning attorney about whether you should "transmute" any of the pre-marital property to community property.

This concept also applies to California state registered domestic partners (also known as "CSRDPs" or "RDPs"). Since 2005, CSRDPs have all the same rights and responsibilities of marriage under California state law, but not federal law. CSRDP also recognizes marriage equivalent status from other states, such as civil unions from Vermont, so long as the rights and responsibilities are substantially similar to those of CSRDPs.

What is transmutation?

Transmutation is the legal term for changing community property to separate property or vice versa. Nine state, including California, have default community property rules, and one additional state allows couples to opt-in. In California, a transmutation requires a clear writing by the spouse or domestic partner giving up an interest. Also, for CSRDPs, transmutation should be done with extra care, because it might require filing of a federal gift tax return Form 709, due to the fact that CSRDPs are not recognized as married under federal tax law, and thus do not benefit from the unlimited marital deduction from federal gift or estate tax.

What is community property and separate property?

Many couples mistakenly believe that all property automatically becomes community property and is thus equally owned upon date of marriage or CSRDP registration. This is a common but incorrect myth. In reality, the default rule in California for married couples and CSRDPs states that all property from before the marriage or CSRDP is 100% separate property of the spouse or CSRDP who owned it prior to marriage or registration. This includes any income generated from the separate property. Separate property can also be acquired after marriage or CSRDP registration by gift or inheritance.

Only property acquired during marriage from the labor of either spouse or CSRDP (e.g. from your job) is considered community property. Community property can also be created by commingling of community and separate property, or with transmuting by clear written intent of either spouse or CSRDP.

Community property is owned 50/50 by each spouse or CSRDP, and separate property is owned 100% by the relevant spouse or CSRDP.

If a couple wishes to change how the default rule affects them, or to clarify which property is community versus separate property, that couple should consider a pre-marital or post-marital agreement (also called pre-nuptial or post-nuptial), or in the case of CSRDPs, a pre-registration or post-registration agreement. The requirement of marital and registration agreements are basically the same, except that CSRDPs who are not also married should be cautious of transfers of interest greater than $14,000 which would trigger a filing requirement for a federal gift tax return Form 709, as described above. Also, couples should be aware that these agreements typically require representation by separate family law counsel.

Why do couples care about what property is community versus separate?

Couples generally care about community and separate property at two potential points in time – divorce and death.

In the event of divorce (or "dissolution"), community property is divided in half, and separate property is not. Disputes can arise where there is commingling or ambiguity about whether property really is separate or community.

In the event of death, the following are the two main issues: (1) distribution of property such as when you do not leave everything to your spouse or CSRDP (you can only leave things that belong to you), and (2) capital gain tax advantages at the death of the first spouse or CSRDP. The capital gain advantage is what can save hundreds of thousands for a surviving spouse or CSRDP, or more specifically, the "double step-up in capital gains basis for community property."

How community property can save hundreds of thousands for the surviving spouse or CSRDP

The "double step-up in basis" works as follows.

When I purchase a capital asset, such as real property (house, condo, land) or business interests (stocks, bonds, mutual funds), the purchase price is the "capital gains basis." For real property, the "basis" is increased also by anything I spend on improvements (but not repairs). So when I later sell that asset, the "basis" is subtracted from the sales price for a capital gain or a capital loss. Capital losses can be used to offset capital gains, and to a limited extent can offset ordinary income. Capital gains are taxed at 15-20% federally, plus 3.8% for the federal Net Income Investment Tax ("NIIT" tax, for investments and investment property), plus in California, an additional 1% - 13.3% in state income taxes.

So for example, if I purchase an investment property in equal shares with my spouse for $100,000, and then we spend $100,000 in improvements, our capital gains basis is $200,000. If we sell the property at $1,000,000, our capital gain is $800,000, or $400,000 each. Calculated at 20% federal capital gains tax, plus 3.8% NIIT tax, plus $13.3% state income tax, or the resulting tax is 37.1% total, or $296,800.

Alternatively, let's say my spouse and I purchased the property before we were married. If we then marry and never transmute the property to community, that property would be considered 50/50 separate property. If I then pass away, the basis on my half is "stepped-up" to date of death value, which is the current rule for all capital assets upon death of the owner. If that date of death value is $1,000,000, the basis on my half is now "stepped-up" to $500,000 (1/2 of $1,000,000), while the basis remains $100,000 on my spouse's half (1/2 of the original $200,000 basis). If my spouse then sells the property for $1,000,000, the capital gain is only $400,000, which basically cuts the tax by about half, or $148,400.

Finally, if my co-owner is my spouse or CSRDP <u>and the property is held in community property</u>, and if I pass away before the property is sold, we get special treatment. This would happen if we purchased the property together after marriage or CSRDP registration, or if we transmuted the property with a deed or an agreement afterward. In this situation, if I then pass away, the basis on <u>both halves</u> are stepped up to fair market value. This is called the "double step-up in capital gains basis" or "double step-up in basis" for short. ***Specifically, if the value on date of death is $1,000,000, and then the surviving spouse then sells it immediately for the same amount, the double step-up in basis results is no capital gain, and no tax for surviving spouses.*** Surviving CSRDPs are eligible for the double step-up in basis only on the state level, and in this example, would still have a $400,000 gain on the federal level. As a reminder, the reason is that CSRDPs are not recognized as married under federal tax rules.

So What Can We Do About It?

1. <u>Come to our workshop</u>
   If you are a same-sex couple interested in more information on capital gains issues as it relates to marriage and CSRDP registration, we will be offering two more workshops in 2015 for LGBT couples on this issue. These workshops are tailored specifically for same-sex couples, but opposite-sex couples are welcome to attend, as some of the issues apply to all married couples. On Wednesday, October 28, 2015, Bank of the West is hosting a program in San Francisco at the Castro Branch 5:30-7:30 p.m., and on Saturday, November 7, 2015, we are co-hosting a program with Robert Castillo of Gerber Kawasaki Wealth & Investment Management at the Long Beach LGBTQ Center. For more information or to register, please visit our <u>website</u> or email Jack Seabolt, <u>jseabolt@lakinspears.com</u>.
2. <u>Consult with your estate planning attorney</u>.
   For all couples, if you are considering marriage or CSRDP registration, have recently gotten married or registered as CSRDPs, or have had your marriage recently recognized by the federal government (such as under the *United States v. Windsor* decision in 2013 for same-sex married couples), you may want to check with your estate planning attorney about what property is

community property, and whether it makes sense to consider a transmutation. Transmutations are typically handled by deed or by agreement.

If you need assistance with the analysis, our office can help. For an appointment with Alma Soongi Beck, or a referral or a competent attorney in your region, you can contact Jack Seabolt, jseabolt@lakinspears.com, (650) 289-6429.

3. Consult with a family lawyer that handles marital and CSRDP agreements.

   While a deed may be sufficient to transmute some real property, many real property transmutations also require written agreements drafted by a licensed family law attorney. Transmutation of business and stock accounts to community property also typically require transmutation agreements. Important to note is that one or both spouses or CSRDPs may require separate counsel, especially if that person is giving up an interest.

   If you need assistance with the transmutation, our Firm has several family law attorneys who handle marital and CSRDP agreements who may be able to help. Feel free to contact Geniveve Ruskus, Tanya Prioste, Rita Patterson, and Lydia Crandall, at (650) 328-7000, or by email at gruskus@lakinspears.com, tprioste@lakinspears.com, rpatterson@lakinspears.com, lcrandall@lakinspears.com.