

Estate Secrets

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You are approached by a client to prepare a document that transfers one spouse's separate real property into community property for estate planning purposes. The intention of your client is to have this real property be considered community property as far as the IRS is concerned. The purpose for this property transfer is to ensure that when either spouse dies, the survivor can obtain a full step up in basis to the fair market value of the property at the time of the spouse's death and therefore significantly reduce the capital gain on the property and any taxes due at the time of sale. With a new ruling by the 4th District of Court of Appeal, drafting such estate planning documents has become more complicated. With *In re Marriage of Lund*, 174 Cal.App.4th 40 (2009), the Court of Appeal has made it clear it essentially will not help married couples have their cake and eat it too by entering into such agreements for estate planning purposes in order to avoid higher taxes. When faced with these circumstances, estate planning attorneys must fully explain the legal ramifications of such documents to their clients.

Married people may, by agreement or transfer, transmute the separate property of either spouse to community property. This "transmutation" has to be in writing by an express declaration that such a transfer is being made and accepted by the spouse whose interest in the property is being adversely affected. This declaration has to be clear and unambiguous in its intent to change the ownership of property. In California, there is no authority for the proposition that a transmutation, once affected, can be conditional to the event the parties are married and one spouse dies. This would allow the spouses to obtain a full step up in basis to the fair market value of the property at the time of a spouse's death, while simultaneously denying the transmutation agreement as an instrument that created community property.

The advantage of having real property characterized as community property is, when one spouse dies, both receive a stepped-up basis to the fair market value of the property at the time of the spouse's death. With a higher stepped-up basis on the entire property, i.e. the home, the resulting capital gain is significantly reduced and any taxes due on the subsequent sale of the property are likewise reduced. When

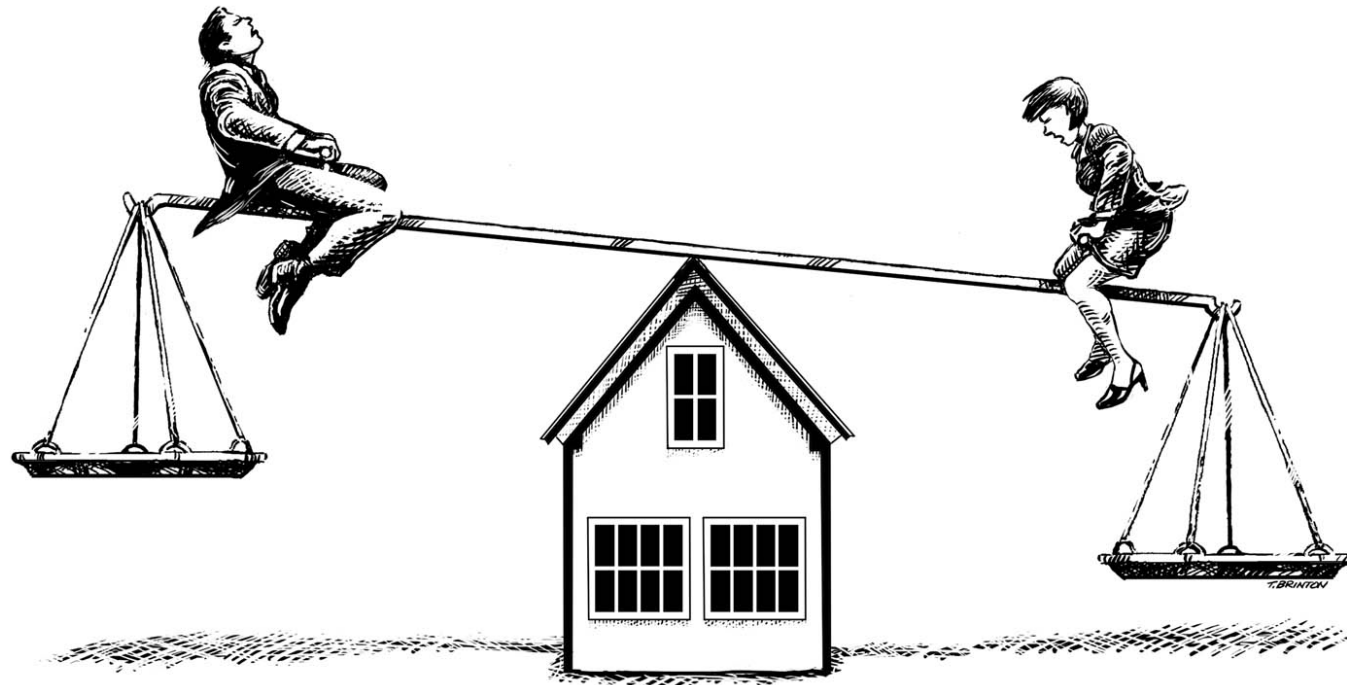
the basis on real property goes up, the taxes owed on the sale of the real property go down.

In *In re Marriage of Lund*, the Court of Appeal found a writing signed by the adversely affected spouse is not considered an "express declaration" sufficient to transmute his or her separate property into community property, unless it expressly states that it is changing the character of the separate property into community property and it clearly indicates it is changing the ownership of the property.

The Court of Appeal has made it clear it essentially will not help married couples have their cake and eat it too by entering into such agreements for estate planning purposes in order to avoid higher taxes.

In this case, the parties, Kathryn and Earl, were married in 1990. In 2002, the parties entered into an agreement titled "Agreement to Establish Interest in Property of Earl E. Lund, Jr. and Anne K. Lund." Anne K. Lund was the name used for Kathryn and not a disputed issue in this case.

The agreement provided in part the following: "The Husband, for estate planning purposes desires to convert said separate property into community property... All ... property, real or personal, of the parties hereto, whether title thereto is held in the names of one or the other of the parties or both of the parties as joint tenants or otherwise, is the community property of the parties hereto, each having a present, existing, and equal interest therein. ... All of the property, real and personal, held in the name of Husband having its origin in his separate property no matter how received and/or earned, is hereby converted to community property of Husband and Wife, and shall thereafter be the com-



munity property of the parties for estate planning hereto, each having a present, existing, and equal interest therein... This Agreement is intended as a document of transfer for estate planning purposes to the extent necessary to conform the record ownership of the properties of the parties to the within Agreement. It is not intended by this Agreement to make any transfer of property between the parties hereto, nor shall this Agreement be construed for any purpose to affect any such transfer, but this Agreement is executed solely for the purpose of recognizing as between the parties the type of ownership of the properties acquired and now owned by them. In addition, the parties agree to join the execution of such other deeds, assignments or documents as may be required to reflect the formal record ownership in accordance with this Agreement."

Stripped down to its essentials, if accepted, would interpret the agreement as effecting a transmutation of Earl's separate property to community property only if Earl or Kathryn died while married. The language of the agreement, however, also clearly disclaimed the notion of a conditional transmutation by providing, "all of the property, real and personal, held in the name of husband having its origin in his separate property no matter how received and/or earned, is hereby converted to community property of Husband and Wife, and shall thereafter be the community property of the parties for estate planning hereto, each having a present, existing, and equal interest therein."

What was even more interesting about Earl and Kathryn's agreement was that it included a clause that stated, "Nothing contained herein shall be construed so as to require the commission of any act contrary to law." The court took this clause to mean that the parties intended to execute the

agreement for the sole purpose of providing documentary support to a future materially false representation to the IRS.

When faced with these testamentary documents that transmute property, California courts find the underlying motivation of creating the document is irrelevant. The relevant question when the document comes under review is whether it contains the requisite express, unequivocal declaration of a present transmutation. The intention behind the estate planning documents do not have any bearing on the fact that an agreement contains and express declaration of a present transmutation.

Another aspect of such agreements about which attorneys should be very cautious is whether the aggrieved spouse was unduly influenced to enter into such an agreement. For example, here Earl claimed he was unduly influenced to enter into the agreement, but the court found that Kathryn had successfully demonstrated Earl entered the transaction voluntarily with an understanding of all relevant facts, but failed to rebut the presumption that Earl did not understand the legal effect of the transaction.

When an agreement between married people advantages one spouse over the other, the law, from a public policy standpoint, presumes that such a transaction was induced by undue influence. When a presumption of undue influence applies to a transaction, the spouse who was advantaged by the transaction must establish that the disadvantaged spouse's action was freely and voluntarily made with a full knowledge of all the facts and with a complete understanding of the effect of the transaction. It is the responsibility of the spouse's attorney to explain all the facts and the legal ramifications of entering into such an agreement with the spouses.

In this case, Earl had signed under the following statement: "I have carefully read

and understand all of the provisions of the foregoing agreement and approve of and agree to all of the terms hereof." The Court of Appeal found this, along with the fact that both Earl and Kathryn were represented by counsel, was sufficient to prove that Earl understood the legal importance of the agreement. There was no other evidence of Earl's understanding of the legal effect of the agreement.

It is essential in drafting estate planning documents to advise clients of all legal ramifications and explain that they can serve as agreements effecting transmutation of separate property to community property. The clients must understand that transmutation of property cannot be limited solely to estate planning purposes. Should the married couple enter into such an agreement for estate planning purposes, but before either one dies they file for dissolution of their marriage, the agreement can be used to show transmutation of separate property to community and the properties will be divided equally. *Lund* is instructive to estate planning attorneys approached by their clients to draft or review such agreements to be very careful in handling these matters. It is highly advisable for the attorney to confirm in writing with the client that he or she has fully explained the legal ramifications of entering into such estate planning agreements to the client and that the client has fully understood the legal ramifications and regardless decided to proceed with the agreement.

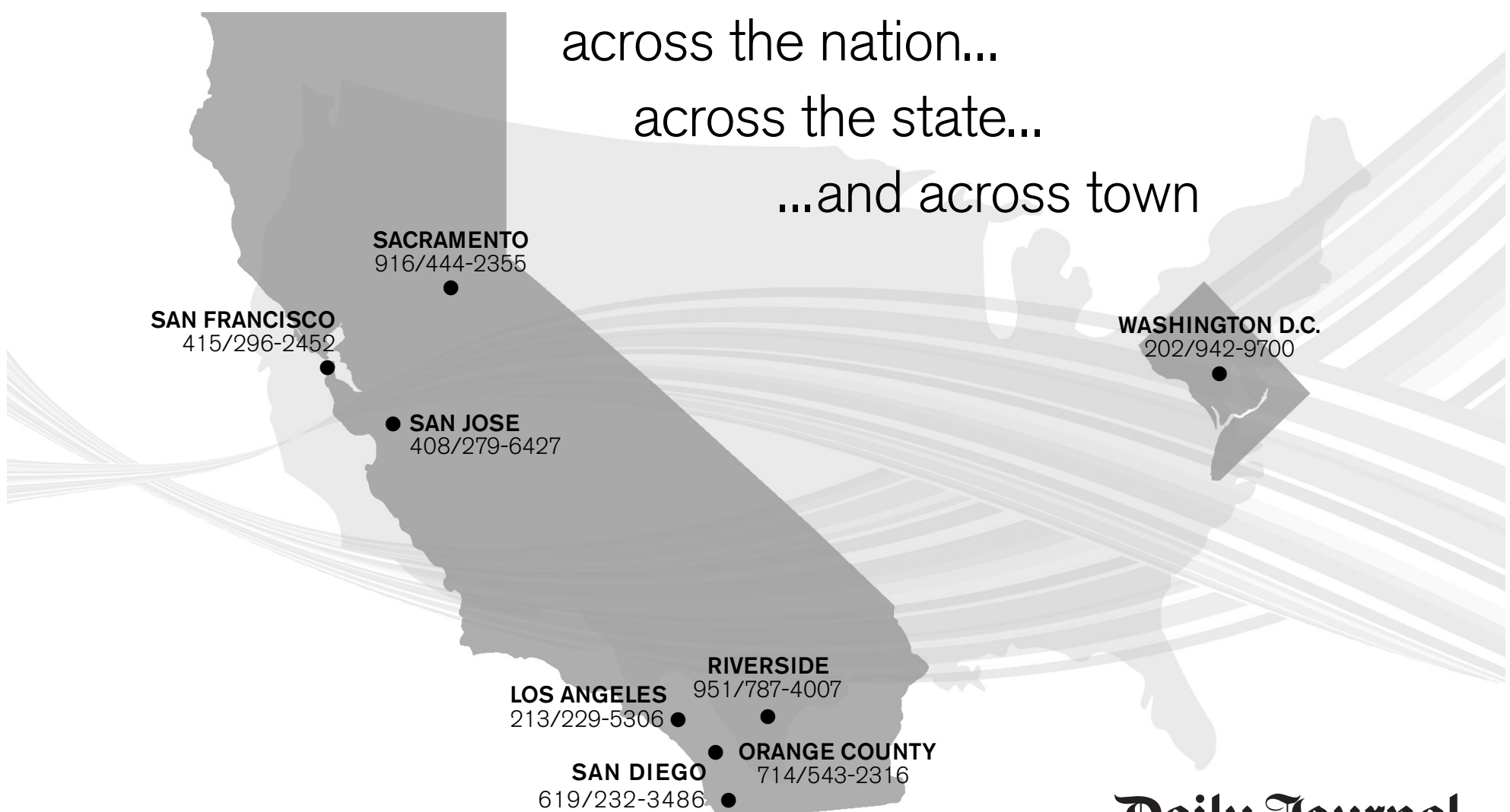
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