

## **Asset Protection and Community Property (California)**

### **California Community Property/Liability for Judgments**

#### 1. California Statutory Collection Laws

CCP Section 695.010(a) provides that all property owned by the debtor, subject to certain exceptions, is subject to enforcement of a judgment. Community property owned by a debtor's spouse is included within the "all property owned by the debtor." (CCP Section 695.020(b))

Additional costs and interest may be added to the judgment. As money comes in from the debtor to the creditor, it is first applied to satisfy any additional costs and interest, and only then, the principal balance of the judgment. (CCP Sections 695.210 and 695.221) Interest accrues only on the original amount of the judgment unless judgments are periodically re-recorded, in which case interest compounds.

Judgments continue to exist for 10 years from the date of entry of the judgment. (CCP Section 683.020) Judgments may be renewed for additional terms of 10 years. (CCP Section 683.110(a) and 683.120(b)).

Judgments are usually collected through the lien mechanism. The

creditor will place a lien on the debtor's real and personal property (by recording the judgment with the county recorder's office or entering it with the Secretary of State), and the lien will be satisfied when the property is sold by the debtor or foreclosed upon by the creditor.

Once the underlying judgment is satisfied, the lien must be released.

(CCP Section 697.050)

A judgment lien on real property is created when the judgment is recorded in the county where the debtor owns real property. (CCP Section 697.310(a)). The judgment must be recorded in each county where the creditor wishes to create a lien against the debtor. The judgment lien continues to exist for 10 years from the date of the judgment, unless it is renewed. (CCP Section 697.310(b)).

A judgment lien on personal property is created when notice is filed with the California Secretary of State and continues for 5 years.

(CCP Section 697.510)

In addition to collecting through the lien process, a creditor can collect through the writ of execution. (CCP Sections 699.010 through 699.090) A writ of execution is issued by the clerk of the court where the creditor obtained its judgment. (CCP Section 699.510) The writ of execution directs the county sheriff to secure the debtor's

property in that county. Thus, the writ of execution is a levy. A separate writ of execution must be issued for each county where the creditor intends to levy on the debtor's property. The writ of execution is effective for 180 days.

All property owned by the debtor that is subject to a judgment may be levied upon through the writ of execution process. (CCP Section 699.710) This includes real property, but the levy must first be recorded in the county where the real property is located. (CCP Section 700.015(a)) There are several exceptions, which include the interest of a partner in a partnership or a member in a limited liability company, the loan value of a life insurance contract, and the interest of a beneficiary in a trust. (CCP Section 669.720)

Once the levied property is collected by the sheriff, whether real or personal, the property is sold at a foreclosure sale to the highest bidder, for cash or cashier's check. (CCP Section 701.510) For tax liens, the property cannot be sold until the bid amount exceeds the state tax lien on the property and the exemption amount for the claimed property. Once the property is sold at the foreclosure sale, the lien on such property is extinguished.

Following the foreclosure sale the sheriff remits the amount

collected, less certain costs, to the creditor, unless the property was subject to other liens with a priority higher than the judgment creditor. In that case the creditors are paid off in the order of their priority, and any amount left over is remitted to the debtor. (CCP Section 701.810)

It is important to note that foreclosures of mortgages are subject to special rules. (See CCP Sections 725a-730.5)

In some circumstances, the creditor may attempt to obtain a turnover order – a court order directing the debtor to turn its assets (usually a specific asset) over to the creditor.

## 2. Other Creditor Remedies

At any time while the creditor has a judgment outstanding against the debtor, the creditor may serve upon the debtor written interrogatories demanding information from the debtor which will assist the creditor in satisfying the judgment. Similarly, the creditor may demand documents and records from the debtor which will assist in satisfying the judgment. (CCP Sections 708.020 and 708.030)

The creditor may also require the debtor to appear for a debtor exam before a court or a court appointed referee. (CCP Section 708.110) At a debtor exam, the debtor may be required to produce books and records, financial information, witnesses and answer a

battery of questions about past employment history, ownership and transfers of assets and any other information that would assist the creditor in locating debtor's assets.

If a creditor has a judgment against a partner in a partnership or a member of a limited liability company, the creditor can apply for a court order charging the interest of the partner/member in the entity. (CCP Section 708.310) Notice of the charging order must be given to all partners or all members of the entity. (CCP Section 708.320)

A creditor may also levy on the debtor's wages through the means of a wage garnishment. (CCP Section 706.020-706.034) The creditor cannot garnish the entire wage of the debtor. Pursuant to federal law, followed in California, the maximum the creditor can garnish is the lesser of: (i) 25% of the debtor's disposable earnings for the week, or, (ii) the difference between disposable earnings for the week, and (b) thirty times the federal minimum wage. (15 U.S.C. 1673(a). The current federal minimum wage is \$5.15 per hour. 29 U.S.C. 206(a)(1)) However, if the garnishment is to satisfy a support order, up to 50% of disposable earnings can be garnished. (15 U.S.C. 1673(c))

### 3. California Law – Community Property

If assets constitute community property, it is usually

irrelevant that the assets are titled in the name of one spouse. The creditor can attach all of the community property, even if only one spouse is the debtor. This may hold true even if the debt arose prior to the marriage. (See CCP Sections 695.020, 703.020 and 703.110.)

**In community property states**, most property acquired during marriage is treated as community property. Even if property so acquired is titled in the name of one spouse, that merely creates a rebuttable presumption as to the community or separate nature of such property. Because each spouse has a coextensive ownership interest in community property, creditors of either spouse can reach all community property of the two spouses.

However, on divorce, the treatment of the spouses' property is different. All property acquired during marriage, (other than by gift or inheritance) regardless of how it is titled, is treated as marital property, and is subject to a division on divorce. Generally, in a common law state, marital property will be any property owned by a spouse except: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property designated as nonmarital through an agreement between spouses.

**During marriage, the creditor can reach only the property**

**titled in the name of the debtor spouse. However, on divorce, all marital property will be divided, regardless of how it is titled and may become reachable by a creditor.**

#### 4. Community Property Jurisdictions – Overview of Community Property

In a community property state there are two types of property: separate and community. (There is actually a third form of property in a community property state: quasi-community property. Quasi-community property is real and personal property, wherever it is located, that would have been community property had the spouse been domiciled (resided) in California when he or she acquired it, or any property acquired in exchange for such property.) Separate property is acquired in much the same manner as in common law states: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property acquired during marriage but as to which the spouses entered into an agreement treating it as separate property. (California Family Code Sections 770(a) and 850(a))

Separate property in a community property state is afforded similar treatment to separate property in a common law state. During

marriage, a creditor of one spouse cannot reach the separate property of the other spouse. However, the one important distinction is that in a community property state, separate property is separate for all purposes, including divorce. In common law states separate property may also be marital property, subject to an equitable division on divorce.

Community property is a form of joint ownership of property by husband and wife. It is defined as real or personal property, wherever situated, acquired by a married person during the marriage while domiciled in this state. Each spouse can manage, direct and control community property.

The distinctive feature of community property (Community property states include: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.) is that both spouses own coextensive interests in all of community property. This means that a creditor of one spouse can reach all the community property of the spouses.

California Family Law Code Section 910(a) provides:

Except as otherwise expressly provided by statute, the community estate is liable for a debt incurred by either spouse before or during



marriage, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.

The liability of community property extends to contracts entered into by either spouse during marriage, to torts of either spouse during marriage, and to most pre-marriage obligations of either spouse.

#### 5. Characterization of Community Property – Generally

The five major factors affecting characterization of property as separate or community are the following: (i) time of the property's acquisition; (ii) the source of funds used to acquire the property; (iii) whether spouses entered into a "transmutation agreement" to change the character of property from community to separate, separate to community, and from the separate property of one spouse to the separate property of the other spouse; (iv) actions by parties, including actions that "commingle" or combine separate and purchased or money borrowed is presumed to be community property. The general rule is that property acquired during marriage is community property.

For property acquired during marriage, it is important to establish not only the actual amounts of separate and community contributions,

but also their respective proportions. Thus, when the property appreciates in value, it will be still possible to apportion.

#### 6. Pursuing a Separate Business

When one spouse devotes time during marriage to develop his or her separate business and the business appreciates in value, then a portion of that appreciation is attributable to the community. During marriage the time of each spouse belongs to the community, and the time expended on a separate business is community's time.

California courts have established complicated formulas to apportion the appreciation in value between separate property and community property.

#### 7. Transmutation

Married persons may, by agreement or transfer, and with or without consideration, change or "transmute" the character of their property in any of the following ways: (i) from community property to separate property of either spouse; (ii) from separate property of either spouse to community property; (iii) from separate property of one spouse to separate property of the other spouse. (California Family Code Section 850)

To be effective, a transmutation agreement must be in writing, the

spouses must fully disclose their properties to each other, and a transmutation of real property will be effective as to third-party creditors only if it is recorded. (California Family Code Sections 852(a) and (b). See, also Estate of MacDonald, 51 Cal. 3d 262 (1990).)

The law of fraudulent transfers applies to transmutation agreements. (California Family Code Section 851)

#### 8. The Community Property Presumption

There is a legal inference, called a "presumption," that all property acquired during marriage by either husband or wife or both is community property. (California Family Code Section 760)

The general community property presumption specifically applies to the following types of property: (California Family Code Section 760) (i) all real property, including leased property, that is located in California and is acquired during marriage by a spouse while domiciled (living with intent to remain) in California; (ii) all personal property, wherever located, that is acquired during marriage by a married person while domiciled in California; and (iii) all community property transferred by husband and wife to a trust pursuant to Family Code Section 761. However, the general

community property presumption that property acquired during marriage is community property may be overcome by evidence that the disputed property is actually separate property.

Evidence that may be used to overcome the community property presumption includes the following: (i) an agreement between the parties to change the character of (transmute) the property from community to separate property; (ii) tracing property to a separate property source; or (iii) reliance on separate property as collateral when property is purchased on credit.

If the community property presumption cannot be overcome, the party who has made traceable separate property contributions to the acquisition of property may obtain reimbursement in certain circumstances. (California Family Code Section 2640)

There are several statutory exceptions to the general presumption that all property acquired during marriage is community property: (i) property acquired by either husband or wife by gift, will, or inheritance; (ii) property that either spouse acquires with the rents, issues, or profits from separate property; (iii) property held at death and that a spouse acquired during a previous marriage if that marriage was terminated by dissolution more than four years before

death; (iv) any real or personal property interest acquired by the wife by written instrument before January 1, 1975; (v) property acquired by either spouse after separation, unless the property is acquired with community property funds; (vi) property designated as separate by a transmutation agreement; (vii) personal injury damages paid by one spouse to the other spouse if the cause of action arises during marriage; and (viii) personal injury damages received by one spouse from a third party after a court renders a decree of legal separation or a judgment of dissolution of marriage. (See, Family Code Sections 770, 781, 802 and 803)

9. Effect of Title on Community Property – Joint Tenancy and Tenancy in Common

The general community property presumption applies to all property acquired during marriage, including property titled in joint form, such as joint tenancy or tenancy in common. A spouse intending to rebut the community property presumption for jointly titled property may do so in one of two ways: (i) a clear statement in the deed or other documentary evidence of title by which the property is acquired that the property is separate and not community property; or (ii) proof that the spouses have made a written agreement that the

property is separate property.

California community property laws suggests holding assets in a community property form is less desirable than separate property, at least from an asset protection perspective. The reason is that all of community property is liable for the debts of either spouse, whether incurred before or during marriage. Contrast that with separate property, which is only liable for the debts of that spouse who owns the separate property (except for obligations with respect to necessities of life).

In the context of asset protection planning, one may want to convert community property to separate. One way of accomplishing that goal is for spouses to transmute their community property into separate. However, transmutation agreements are subject to the fraudulent transfer laws.

In most community property states, the general rule is that community property can be seized to satisfy community debts even after a divorce. This means that once the community incurred a debt, both spouses are liable for that debt, even following a divorce, and even if the liability has been allocated entirely to only one spouse. (Wilkes v. Smith, 465 F. 2d 1142, 1146 (9<sup>th</sup> Cir. 1972))

In California, this rule has been changed so that community property awarded to a nondebtor spouse as separate property is protected from the claims of his or her ex-spouse's creditors, even if the debts are community debts. This means that a community debt, which is generally an obligation of both spouses, can be assigned to only one spouse, in California. (California Family Code Section 2551)

With respect to the separate property of spouses following a divorce, the allocation and division of liabilities on divorce in California are as follows: (California Family Code Section 916(a))

- a) Separate property owned by a married person and property received by that person pursuant to the division of property is liable for debts incurred by the person before or during marriage whether the debt is assigned for payment by that person or that person's spouse.
- b) Separate property owned by a Married person at the time of the division and other property received by that person is not liable for debts incurred by the person's spouse before or during marriage and the person is not liable for such debt unless it

was assigned to him or her in the division of property.

- c) Separate property and other property received by a married person is liable for debts incurred by the person's spouse before or during marriage and the person is personally liable for the debt if it was assigned for payment by the person pursuant to the division of property.

While a community debt can be assigned to only one spouse (in California), that does not mean that the spouses can assign all of the liabilities to one spouse, and all of the assets to the other spouse. Transfers of property pursuant to a divorce, like any other transfers of property, are subject to the fraudulent transfer laws.

For example, in Britt v. Damson, (Britt v. Damson, 334 F. 2d 896, 902 (9<sup>th</sup> Cir. 1964), cert. denied, 379 U.S. 966 (1965)) the spouses divorced and the husband filed for bankruptcy. There was a claim that the property transferred to the wife pursuant to the divorce was fraudulent. The court held that although the division of property was not fraudulent under state law, it could be under the Bankruptcy Code's fraudulent conveyance provisions. The court stated:

To the extent that the value of the community property ordered to



[the wife] was offset by the value of the community property awarded to husband, the 'transfer' to [the wife] was, as a matter of law, supported by 'fair consideration.'...

To the extent that the award of community property to [the wife] may have exceeded half of the total value of the community property, there is a question whether, under all the circumstances, [the husband] received fair consideration as a matter of law.

The Ninth Circuit thus made it apparent that even on divorce, transfers of property can be scrutinized and tested under the fraudulent transfer laws.

In a more recent case, the California Supreme Court attempted to harmonize California Family Code Section 2551 and the UFTA. (Mejia v. Reed, 31 Cal. 4<sup>th</sup> 657 (2003)) Section 2551 provides that the property received by a person on divorce is not liable for debt incurred by the person's spouse before or during marriage, and the person is not personally liable for the debt, unless the debt was assigned pursuant to the divorce to that person. This means that in California divorce overrides the asset protection disadvantages of the community property system.

In contrast to Section 2551 is the UFTA which provides that any

transfer of property is subject to the laws of fraudulent conveyances.

The California Supreme Court reasoned that the California Legislature has a general policy of protecting creditors from fraudulent transfers, including transfers between spouses. Just as the fraudulent transfer laws apply to transmutation agreements during marriage, so do those laws apply to transfers of property on divorce.

Despite the court's holding the transfers of property on divorce are subject to the UFTA, challenges under the UFTA are still limited in the context of divorce and leave room for planning opportunities. Under the UFTA, a creditor can allege that the transfer was either actually or constructively fraudulent.

Constructive fraud requires little more than a finding that one of the spouses was left insolvent – a straight forward and objective analysis. However, actual fraud requires a subjective analysis which makes it more difficult for a creditor to prevail in the context of divorce.

## 10. Postnuptial and Transmutation Agreements

### **Postnuptial Agreements**

An agreement between spouses after the marriage ceremony and

affecting the spouses' property rights is referred to as a postnuptial agreement. A transmutation agreement is a postnuptial agreement that changes the character of the spouses' property from community to separate, or vice versa.

Postnuptial agreements are governed primarily by the California Family Code Sections 721, 1500 and 1620. Section 721 provides that postnuptial agreements (as opposed to premarital) are subject to the general rules governing fiduciary relationships that control the actions of person occupying confidential relations with each other.

Section 1500 provides general authority for spouses to alter their property rights by a marital property agreement. Section 1620 states that, except as otherwise provided by law, a husband and wife cannot, by a contract with each other, alter their legal relations except as to property.

## **Transmutation Agreements**

### **Generally**

Many postnuptial agreements have as their purpose the change, or transmutation, of the character of the parties' property from separate to community, or vice versa. Spouses are free to alter the character of property in this manner, provided that all statutory

requirements are met. A transmutation agreement may be used to change the character of property to be acquired in the future, as well as property that the spouses own at the time of the agreement.

(California Family Code Sections 850, *et. seq.*)

The principal limitation on transmutation agreements between spouses is that (i) they must be fair and based on full disclosure of the pertinent facts, and (ii) they must not be a fraudulent transfer of assets.

The following are the major considerations pertaining to transmutation agreements: (i) except for certain interspousal gifts, transmutations of real or personal property are not valid unless made in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected; (ii) transmutations may be made with or without consideration; (iii) transmutations of real property are not effective with respect to third parties without notice of the transmutation, unless the transmutation is recorded; (iv) transmutations are subject to the laws governing fraudulent transfers; and (v) a statement in a will of the character of property is not admissible as evidence of a transmutation of the property in any proceeding commenced before

the death of the person who made the will.

### **Tax Effects**

Transmutation agreements have certain tax implications. For income tax purposes, if spouses file a joint return, then characterization of property as community or separate is irrelevant, as all income is aggregated. However, if spouses file a separate return, then each spouse must report his or her one-half share of community income, and his or her separate income. Because transmutation agreements change the nature of the property (including earnings and other income), they have the greatest income tax impact on separate tax returns.

Transfers of property between spouses are generally nonrecognition events for income tax purposes, as they are always considered to be gifts with basis carryover. There are a couple of exceptions: (i) transfer to a spouse who is a nonresident alien at the time of the transfer; (ii) transfer in trust, to the extent that the sum of the liabilities assumed, plus the liabilities to which the property is subject, exceeds the total adjusted basis of the property; or (iii) transfer in trust, of an installment obligation. (See, IRC Section 1041)

The more important tax aspect of a transmutation agreement is

the effect that it has on basis step-up (or step-down) at death.

On a spouses' death, one-half of the community property belongs to the surviving spouse, and the other half belongs to the decedent. (California Probate Code Section 100) If the property has appreciated in value during the time that it was held, the entire property will receive a stepped-up basis equal to its fair market value on the date of the deceased spouse's death, if the decedent's half of the property was included in his or her estate. (IRC Section 1014(b)(6)) The surviving spouse will receive a stepped-up basis in his or her half of the property, and will therefore have a smaller gain on disposition of that property.

By comparison, if the spouses had held the property separately in joint tenancy with a right of survivorship, the surviving spouse would automatically receive his or her half of the property by operation of law through the original joint tenancy title, and not through inheritance or any other type of succession after death. Consequently, his or her basis would not be stepped up if the property has appreciated, but instead would remain at the original cost basis.

While transmutation agreements are generally desirable from an

asset protection standpoint, they may have adverse tax consequences, because of the loss of one-half of basis step up. By carefully coordinating the transmutation agreement with the spouses' will or trust, many of the adverse tax consequences can be minimized or eliminated. For example, if the spouses' residence is the separate property of the surviving spouse, then while the residence will not receive a step-up in basis, up to \$250,000 of gain will be sheltered on the sale of the residence.

The loss of the basis-step up on one-half of property is important only if it is anticipated that the surviving spouse will be selling his or her separate property. If the surviving spouse retains her separate assets and sells the property inherited from the decedent (which received a basis step up), no adverse tax consequences will result.

Spouses may enter into a transmutation agreement at any time, during marriage. Accordingly, while the spouses are working or practicing their profession (and they are exposed to risks) they can enter into a transmutation agreement and transfer certain assets to the low-risk spouse. When the spouses retire and risks dissipate, the spouses can enter into another transmutation agreement and convert their separate property back to community, regaining the full

step up.

While postnuptial agreements are generally subject to the same notice and recording rules as premarital agreements, the rules for transmutation agreements are slightly different.

A transmutation of real property is not effective with respect to third parties who are without notice of the transmutation unless the transmutation instrument is recorded. (California Family Code Section 852(b)) While recording is not a prerequisite to the validity of the transmutation as between the spouses, it is a prerequisite in making the transmutation effective with respect to third parties who are otherwise without notice. This requirement is consistent with the fact that transmutations are subject to the laws governing fraudulent transfers.