

# Family Law Focus

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## CASE SUMMARY

This article examines marital estate planning and transmutation of property characterization.

## Making Sense of Marital Property Transmutation in the Context of Funding Revocable Trusts: A Review of Starkman and Holtemann

**A transmutation is a transfer of property between spouses whereby the characterization of the property changes as a result of the transfer.**

**The Problem:** Either 1) estate planners in pursuit of a significant tax benefit applicable to the transfer of community property to a surviving spouse cross the line by accidentally transmuted separate property to community property upon funding a joint marital revocable living trust or 2) clients who once held a generous intention borne of marital happiness lose or forget that objective at the time of divorce.

**The Impact:** Separate property is viewed as community property when the couple divorce.

**The Estate Planner's Job:** Cautiously draft revocable trusts, community property declarations and trust transfer deeds so as to avoid accidental transmutation.

**The Family Law Attorney's Job:** Review revocable trusts, community property declarations and trust transfer deeds in order to rule in or rule out intentional or accidental transmutions.

Accidental transmutions are easy to avoid when funding a marital revocable trust. That said, there many marital revocable trusts in place that crossed the line into transmutation of separate property to community property due to imprecise funding language.

A transmutation is a transfer of property between spouses whereby the characterization of the property changes as a result of the transfer. Property is transmuted from community property to separate property or from separate property to community property by a

**A fine line is approached when estate planning documents seek community property treatment of separate property assets at the time of death while simultaneously preserving the separate property nature of the asset during life for purposes of separate management and control and for the purpose of protection against loss of the asset to divorce.**

writing that expressly confirms that the characterization of the property is being changed by the instrument. *Cal. Fam. Code §852(a); Estate of MacDonald, (1990) 51 Cal.3d 262.* There are no



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specific words of conveyance required by the writing. The word transmutation need not be used in the writing. The operative concept is that of change; the writing will serve to transmute property if it clearly establishes intent to change the characterization of property.

#### The History of Transmutation

Before 1983, title documents, which then and now carry a presumption of accuracy, could wipe out a spouse's separate property interest without the spouse intending to make a gift of the property. *Marriage of Lucas*, (1980) 27 Cal.3d 808. (Separate property down-payment used to acquire family residence lost to the community when title to the home taken as "joint tenants" in compliance with a realtor's advice.) Moreover, prior to 1984, written and oral evidence could be used to rebut title.

In other words, separate property could be lost in divorce as a consequence of trial testimony that proved that the spouse treated separate property as if it were community property by uttering words that led a spouse to believe a transfer had occurred.

A common evidentiary theme of dissolution trials prior to January 1, 1984 involved casual conversation between spouses or third parties wherein separate property was referred to or treated by the parties as "our property." Prior to 1984, spouses could not be certain that clearly-titled separate property (or separate property that was mistakenly titled otherwise such as joint tenancy or co-tenancy as property frequently is titled upon the advice of realtors, title officers, bankers or financial advisors) would not be lost to an unintentional transmutation or that

oral or written extrinsic evidence would not be used to rebut the presumption of title upon dissolution.

In 1983 the legislature responded to the uncertainty of the 1980 *Lucas* decision and to the general uncertainty suffered by spouses due to the admissibility of oral extrinsic title rebuttal evidence by enacting Cal. Code of Civ. Proc. 4800.2 (since recodified as Cal. Fam. Code 2640.) Cal. Fam. Code §2640 confirmed the date-of-transfer value of separate property to a spouse who contributed that property to the acquisition of community property. The legislature followed in 1984 with Cal. Code of Civ. Proc. §5110.710 et. seq. (since recodified at Cal. Fam. Code §850 et. seq.) which codified the existing rule that spouses can transmute property between themselves but which overruled case law that permitted oral transmutation agreements and allowed extrinsic written and oral evidence of title rebuttal.

The combination of Cal. Fam. Code §852(a) (requiring transmutations to be in the form of a written "express declaration") and *Estate of MacDonald*, 261 Cal.Rptr. 653 (defining "express declaration" as a clear showing of a party's intent to change the affected property interests) made it clear that transmutations must be the product of unambiguously intentional conduct.

#### The Road Just Got Slippery Again

The rules applicable to transmutation were brightened by the statutes and case law after 1983. The Fourth District Court of Appeal told us in *Marriage of Koester*, (1999) 73 Cal.App.4th 1032, that, largely due to the strengthening of the transmutation rules in 1983 and 1984 as refined by subsequent case law, a person cannot "slip into a

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transmutation by accident.” The Second District however shows us how that can happen through common marital estate planning documents.

Of concern lately is the risk of transmutation that arises when separate property assets are transferred into a joint revocable trust established during marriage.

Two recent Second District Court of Appeal cases provide tools that help us determine whether estate planning documents transmute separate property to community property. In 2005, the Second District Court of Appeal gave us an example of an estate plan that does not transmute separate property to community property, *Marriage of Starkman*, (2005) 129 Cal.App.4th 659, and then followed in 2008 with an example of an estate plan that does transmute separate property to community, *Marriage of Holtemann* (2008) 162 Cal.App.4th 1175.

That both cases come from the Second District is of tremendous import. Had Starkman and Holtemann come from different appellate districts we would have been left with what would look like a split of authority on the issue of whether revocable estate planning documents can transmute separate property to the community. All estate plans are somewhere between Starkman and Holtemann on the spectrum of proof of transmutation and non-transmutation. The challenge for family law attorneys is to determine where on the spectrum our client’s estate planning documents lie and whether they lie in the zone marked transmutation.

#### The Reason There is a Problem

Estate planners sometimes want their cake and eat it too when transferring

separate property to surviving spouses. Characterizing the decedent spouse’s separate property as community property at the time of death may have significant tax advantages to the surviving spouse due to the “double step up” in basis applicable to community property that passes to the surviving spouse. [IRC §1014](#).

The fact that community property receives a full double step up in basis can be convenient if a separate property owner transmutes separate property to the community during marriage and then recovers sole ownership of that same property as beneficiary of the decedent spouse’s estate. If the property remained separate property it would not receive a basis step up on the death of the non-owner spouse. If the separate property is transmuted to community property during marriage and the survivor gets the property back at the death of his spouse the survivor now has a new fully stepped up basis in the property.

A fine line is approached when estate planning documents seek community property treatment of separate property assets at the time of death while simultaneously preserving the separate property nature of the asset during life for purposes of separate management and control and for the purpose of protection against loss of the asset to divorce.

#### The Estate Planning Process

It is quite common for married couples to prepare joint estate plans. Married couples visit an estate planning attorney together. Their attorney advises them on the creation of a revocable trust and related documents that provide for probate avoidance and plan for an orderly distribution of assets upon the

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deaths of the spouses. Estate tax planning will vary depending on the complexity of the estate however even the most basic professionally prepared estate plan will take advantage of simple estate tax management opportunities that can significantly enhance the after-tax estates of the decedent spouses.

#### The Estate Planning Documents

The objective of most estate plans prepared for married couples is to transfer all assets to the surviving spouse and then distribute the assets to the children or to others upon the death of the surviving spouse. Both separate and community property is commonly transferred to the surviving spouse. Community property left to the surviving spouse receives a double step up in basis upon the death of the decedent spouse.

The operative documents most typically prepared in connection with a marital estate plan are the Revocable Trust, an Assignment of Assets, Trust Transfer Deeds and a Community Property Declaration. Each of these documents must be reviewed for possible transmutation problems.

The Revocable Trust establishes the rules for management during life and distribution at death of the separate and community assets transferred to the trust by the spouses.

The General Assignment of assets is used to transfer personal property and financial accounts to the trust and sometimes to memorialize intent that real property be considered assets of the trust. The assignment will typically transfer both separate and community property to the trustees of the revocable trust.

Real property, both separate and community is transferred to the trustees by way of Trust Transfer Deed.

The Community Property Declaration is a statement that confirms that some or all of the marital estate is community property. The Community Property Declaration is intended to certify that assets qualify for the double step up in basis upon the death of the first to die. To this end, there are many estate plans out there that specifically certify that all property owned by both or either of the spouses is confirmed as community property of the married couple regardless of the state of the title before transfer to the trust or the current state of the title if the property is not conveyed to the revocable trust. The Community Property Declaration will commonly make the wholesale statement that all property owned by both or either of the parties is community property regardless of the state of the title. This addresses the fact that community property that is left to the surviving spouse is granted a “double step-up” in basis .

#### Divorce Usually Changes the Intent of the Parties as to How Assets are to be Held

A problem occurs when divorce, rather than death, ends the marriage.

The courts in both cases had to determine whether the language of the respective estate planning documents transmuted property between spouses. Transfers of property rise to the level of a transmutation only if the standards set forth in [Family Code §852\(a\)](#) as interpreted by *Estate of McDonald*, (1990) 51 Cal.3d 262, are satisfied. [Family Code §852\(a\)](#) provides that:

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A transmutation of real or personal property is 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.

*Estate of McDonald*, (1990) 51 Cal.3d 262, refined the rules applied to a writing that one party alleges to be a transmutation by defining what is meant by an express declaration. The McDonald court held that:

Under Civ. Code, § 5110.730, subd. (a), (the predecessor to Cal. Fam. Code §852) providing that a "transmutation of real or personal property is not valid unless made in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest is adversely affected," a writing signed by the adversely affected spouse is not an "express declaration" for the purposes of the statute unless it contains language which expressly states that the characterization or ownership of the property is being changed. The statute precludes reference to extrinsic evidence in the proof of transmutation. However, it does not require use of the term "transmutation" or any other particular locution.

In both recent cases the husband owned substantial premarital separate property assets that were incorporated into the joint estate plan. The first case, *Marriage of Starkman*, the court found the estate planning documents prepared for the parties did not rise to the level of a writing that expressly states that the characterization or ownership of the property was being changed by the documents. The second case, *Marriage of Holtemann*, the court found that the estate planning documents did expressly state that the characterization or

ownership of the property in question was being changed by the documents.

#### Starkman: Not a Transmutation

In 1997 Christopher Starkman, heir to the United Parcel Service fortune, transferred his substantial separate property estate into The Starkman Family Revocable Trust, a revocable trust that was co-settled with his wife of seven years. The trust agreement provided that the property transferred to the trust is community property unless husband or wife as transferor identifies it as separate property. Christopher did not so identify the property.

In 2003, Christine Starkman, Christopher's wife, filed a petition for divorce and sought her community property share of Christopher's separate property, claiming that the transfer to the revocable trust, which internally classified the asset as community, was a transmutation.

Christopher was expressly put on written notice by way of a letter from the attorney who drafted the estate plan that "the Trust provides that there is a presumption that all trust assets are your community property unless you clearly specify otherwise." Christopher still did not so designate his separate property.

The trial court found that Christopher did not state an "express declaration of transmutation" and that his transfer of separate property to the trust did not change the characterization thereof.

The take-away from the Starkman case is that once-separate assets that are classified by estate planning documents as community property are not community property absent a writing memorializing the conveyance to the trust as one that incorporates a change of

characterization. The key to the analysis of the characterization of once-separate property held by a revocable trust is a link in the chain of title that establishes a change point. In other words, you can label separate property as community property and not effect a transmutation but if you establish a point at which the characterization changes there is a transmutation.

#### Holtmann: A Transmutation

Frank and Barbara were married only three years. During their short marriage the Holtmanns settled a joint revocable trust into which Frank transferred substantial separate property. The trust language specifically qualified the purpose of the estate plan by stating that “this agreement is not made in contemplation of a separation or marital dissolution and is made solely for the purpose of interpreting how property shall be disposed of on the deaths of the parties.” When Barbara filed for divorced Frank relied on the qualifying language when he argued that his separate property remained separate property regardless of the label attached to the property by the estate planning documents.

The trial court disagreed with Frank and found that the Holtmann estate plan went farther than did the Starkman estate plan in characterizing property as community property. The Holtmann estate planning documents included a document entitled “Spousal Property Transmutation Agreement” which explained that “(h)usband agrees that the character of the property described in Exhibit A is hereby transmuted from his separate property to the community property of both parties.

The Holtmann trial court found that “(a) clearer statement of a transmutation

is difficult to imagine.” Frank argued that the transmutation was or should have been conditioned such that it would be inoperative upon marital dissolution. Although this may have been Frank’s understanding of the mechanics of the estate plan the court was not persuaded. The court dismissed Frank’s argument that in the event of either his or Barbara’s death, the survivor would be able to use the Transmutation Agreement to claim the property as community property, thus obtaining a full step up in basis to the fair market value of the property at date of death, while at the same time denying the validity of the Transmutation Agreement as an instrument which created community property under other circumstances such as divorce or separation.

In Holtmann, at least one of the parties believed that the classification of the once-separate property as community property was borne of a purely tax-motivated estate planning purpose. The court clearly was not interested in ignoring a clear expression of transmutation, one in which the transferor acknowledged a clear point of change, in deference to a tax-motivated estate planning technique designed to obtain a double step up in basis.

Had the Holtmann marriage ended in Barbara’s death rather than Barbara’s petition for dissolution Frank would have recovered his once-separate property from the revocable trust albeit with a stepped-up basis. The risk of such a clearly designed and definitive expression of community property is that divorce might interfere with such a myopic estate plan.

Ironically, although the Holtmann method of establishing certainty in acquiring a step up in basis

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unquestionably guarantees a double step up in basis upon the death of a spouse the Starkman method of calling separate property community property (even though it is not community property) would likely have been sufficient to obtain a double step up in basis upon the death of a spouse.

Family law attorneys are well aware of the fact that it is quite possible for separate property to accumulate a community property component during marriage whether or not there is a formal transmutation. Therefore, a frequent theme of a decedent's trust administration is distinguishing community property from property that was once separate property and applying a double step up in basis to the property. See *Pereira, Van Camp, Moore, Marsden*, etc.

Very simply stated, basis is the cost or purchase price of an asset plus cost of improvements to the asset. Basis is subtracted from the sales price of an asset to determine the taxable gain attributable to the sale.