Marital Property

Overview

American has two systems for how a married couple can own property: ***common law*** and ***community property***. Nine states—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—have adopted some aspects of a community property system. Alaska has adopted a law that allows couples to voluntarily convert their assets to community property. All other states follow the common law system. The type of marital property system can have an enormous effect on a couple's estate planning.

Description & Operation

Common Law System

Under the common law system, property generally belongs to the spouse who earned the property or received the property by gift or inheritance. Also, property purchased with a spouse's property is his or hers. A spouse may obtain rights in the other spouse's property upon divorce (e.g., by property division or alimony) or death (e.g., through the exercise of a right to an elective share or other spousal support provisions of state law).

A couple can own a piece of property jointly under the common law system in one of three ways.

- **Tenants-in-common**. Each spouse has an undivided fractional interest in the property and can transfer his or her interest by sale, gift, or bequest. Property held in tenancy in common passes as part of a decedent's probate estate.
- **Joint tenants with rights of survivorship ("JTWROS")**. Upon the death of one spouse, the surviving spouse automatically owns the entire property outright. The property passes by the "contract" between the spouses and not by probate.
- **Tenants by the entirety ("TBE")**. TBE is a variation of JTWROS, and is available in fewer than half of the states. TBE is only available to married couples (and, in some states, domestic partners). Unlike JTWROS property, TBE property can only be severed with the consent of both spouses, e.g., in divorce. As a result, TBE may offer greater protection from the creditors of just one of the spouses.

Community Property System

Under the community property system, ownership generally depends on the origin of the property.

- **Separate property.** Separate property is typically property a spouse owned prior to marriage or received by gift, devise, or inheritance. Whether income from separate property remains separate or is community property depends on the state. Some community property states provide that income earned from separate property is separate property, while other states define such income as community property; and some states allow the couples to agree that income will remain separate.
- **Community property**. All compensation earned by a spouse during marriage is community property. And, all property purchased with community property is community property. In some states, a couple can agree to convert community property to separate property, or vice versa. If a couple commingles separate property with community property, a court may treat all of the property as community property unless the character of the property can be traced.

  During marriage, a couple owns all community property "50/50." Upon divorce, a court can give part or all of the community property to a spouse depending on various factors, including fault and earning ability. Upon the death of a spouse, death works as a "partition" and the deceased spouse can devise or bequeath 50% of the couple's community property. The other 50% remains the separate property of the surviving spouse.

Qualified Retirement Plans

One controversial issue involves the status of **qualified retirement plans** in a community property state. Since compensation earned by either spouse during marriage is normally community property, it would appear that a qualified retirement plan provided by one spouse's employer is community property. Under this theory, the non-employee spouse should be able to bequeath 50% of the plan in his or her will. But the U.S. Supreme Court has ruled that the Employee Retirement Income Security Act (ERISA) preempts state law to the extent that state law would require distribution to someone other than the designated beneficiary. This effectively eliminates a non-employee spouse's ability to bequeath a community property interest in a qualified retirement plan if he or she dies before the employee spouse.

Property Acquired in a Different State

Often, a couple may acquire property in a state that operates under one system and **move to a state that operates under the other system**. Many states have adopted statutes that preserve the character of property acquired in other states. Also, if a couple owns community property and moves to a common law state, the common law state will often enforce each spouse's community property rights.

Tax Implications

Income Tax

Under current law, upon the death of a spouse, all of a couple's community property (i.e., both halves) will receive a new income tax basis equal to the fair market value of the assets on the date of death. If the decedent's basis is lower than the fair market value of the asset on the date of death, the new basis will be increased ("stepped up"). If the decedent's basis is greater than the fair market value of the asset on the date

of death, the new basis will be decreased ("stepped down"). By contrast, in a common law state, only the deceased spouse's separate assets or half of joint (non-community) property receives the new basis.

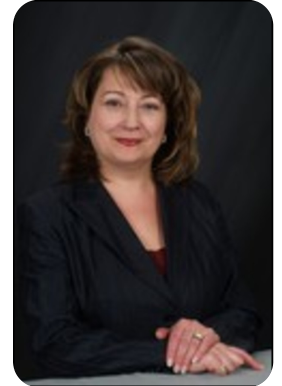
Estate Tax

JTWROS is not available for bypass trust funding. Whether common law or community property applies, if a couple owns all of its property as joint tenants with rights of survivorship, all assets will pass automatically to the surviving spouse. Therefore, the first spouse to die may not be able to fully use his or her estate tax credit. (But see DSUEA comment below.)

As mentioned above, at death, community property receives a basis adjustment on both halves of the property.

Insights and Caveats

Under current law, at the surviving spouse's death, he or she is able to use any unused estate tax credit, i.e., the **Deceased Spousal Unused Exclusion Amount (DSUEA)**. This "portability" extends only to the last deceased spouse, meaning the DSUEA cannot be carried over if the surviving spouse remarries, and an estate tax return must have been filed by the first-to-die spouse. While some couples—particularly in common law states—will take advantage of the DSUEA to obtain a full basis step-up upon the death of the surviving spouse, others may use the first deceased spouse's estate tax credit to fund a "bypass trust" and remove future growth from the surviving spouse's estate, protect assets from creditors, etc.



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