

POSTNUPTIAL AND TRANSMUTATION AGREEMENTS

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THE WOLFE LAW GROUP

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Since 2015 Gary have been the recipient of 29 separate international tax awards from 10 different global expert societies in London/UK including:

International Tax Planning Law Firm of the Year Award (2017) – International Advisory Experts.

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To date Gary has written 18 e-books [\(available on Amazon\)](#) regarding the IRS, International Tax Planning and Asset Protection. [Click here for complete list.](#)

Articles

To date Gary has published or been interviewed in 100+ separate articles published by 15 different US and International magazines. [Click here for complete list.](#)

Video

In December 2016 Gary was interviewed by California CEO Magazine and RCBNNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by [Lorman Education](#), can be viewed below:

[Criminal Tax Evasion - Part 1](#)

[Criminal Tax Evasion – Part 2](#)

[Criminal Tax Evasion – Part 3](#)

[Criminal Tax Evasion – Part 4](#)

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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.

