

## Community Property Law In A Nutshell A Guide for the Layperson

The rules described below are set forth as general but not necessarily inflexible principles. These rules are subject to the subtleties and complexities of the law which may provide various exceptions or unusual or unexpected applications. Obviously, the entire canon of Texas marital property cannot be set forth in this instrument. Further, the fact that you have been advised with regard to the legal conclusions or statements set forth below does not mean that you agree that the conclusions or statements are correct, and neither of you shall be bound by any of the legal conclusions or statements.

- Property owned or claimed prior to marriage is separate property. Property acquired during marriage by gift or inheritance is separate property. The recovery for personal injuries sustained during marriage, except any recovery for loss of earning capacity during marriage, is also separate property.<sup>1</sup> All other property acquired during marriage by either spouse is generally community property<sup>2</sup> (if acquired while domiciled in Texas), including the income from separate property, except as may have been provided by a marital property agreement. However, if one spouse makes a gift of property to the other, the gift is presumed to include all the income and property which may arise from that property (and so in that case the income is separate property).<sup>3</sup> If separate property is sold or exchanged, the property received is still separate property, but only if it can be traced.
- Although the income from separate property is community property in Texas,<sup>4</sup> the increase in value of the underlying asset will retain its separate property character. Determining which is which is not always easy. What may be income for income tax purposes may be treated as a recovery of corpus under Texas community property law. The courts have determined some of the more common issues. For example, the calves of separate property livestock are community property,<sup>5</sup> as are cash dividends from separate property stock; whereas, stock-splits and stock dividends remain separate if the underlying stock was separate. For this purpose, the sale of mineral interests are usually treated as corpus, rather than income, and so royalties from an oil and gas lease are generally treated as separate property. The income of a trust is a special case, and may be community or separate property, depending on the facts.

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<sup>1</sup>Tex. Const. Art. 16 §15; Tex. Fam. Code §3.001(3).

<sup>2</sup>Tex. Fam. Code §3.002.

<sup>3</sup>Tex. Fam. Code §3.005.

<sup>4</sup>Note that the Texas rule, that income from separate property is community property, is the rule in Idaho and Louisiana, but that in the remaining community property states, Arizona, California, Nevada, New Mexico, and Washington, the rule is the opposite.

<sup>5</sup>*Howard v. York*, 20 Tex. 670 (1856).

- Under the “inception of title” rule, the underlying character of property, as being either separate or community, is determined at the time legal title is acquired. Thus, if property was acquired shortly before marriage with a note, and the note was paid during marriage with community funds, the property will be separate property, though the community may enjoy some equitable right to reimbursement, depending on the circumstances.
- Community property is property, other than separate property, that is acquired by either spouse during marriage. All property is presumed to be community property unless it can be proven not to be by clear and convincing evidence.<sup>6</sup> Separate property cannot ordinarily be converted into community property by agreement or otherwise; however, because of the community property presumption, separate property may be presumed to be community property in the absence of clear and convincing evidence to the contrary.
- The character of property acquired in another state, while the owner is domiciled in that state, will generally be determined by the laws of that state. **However, if the property would have been community if acquired in Texas, the property is capable of division on divorce as if it were community property.**<sup>7</sup> For this reason such property is sometimes referred to as *quasi-community property*. Although quasi-community property is divisible upon divorce, for most other purposes it will be treated according to its actual characterization. Thus, the concept has no application at death.<sup>8</sup> Because of the anomalous difference between the probate and divorce treatment of quasi-community property, there have been indications that the legislature may change the probate rule to make it more consistent with the divorce laws.
- During marriage, each spouse has the sole management, control, and disposition of the community property that he or she would have owned if single, including but not limited to personal earnings, revenue from separate property, recoveries for personal injuries and the increase and mutations of, and the revenue from, all property subject to his or her sole management, control, and disposition.<sup>9</sup> This is called sole management community property, and is also sometimes referred to as the *special community* of the controlling spouse.

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<sup>6</sup>Tex. Fam. C. §3.003.

<sup>7</sup>*Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

<sup>8</sup>*Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987).

<sup>9</sup>Tex. Fam. Code §3.102(a).

- A spouse may make gifts to third parties out of his or her special community, without the consent of the other spouse, *within reason*. However, if, by reason of the size of the gift in relation to the total size of the community estate, the adequacy of the estate to support the other spouse, and the relationship of the donor to the donee, the gift constitutes constructive fraud, the burden will be on the donor to prove that the gifts of his share of the community property are fair, otherwise the gift will be set aside.<sup>10</sup> If one spouse makes a gift to a third person of community property, and the other spouse either cannot or does not set the gift aside under state law, the IRS will treat the non-donor spouse as having made a gift for gift tax purposes.<sup>11</sup>
- The characterization of borrowed money and property purchased on credit as either community or separate may depend on the characterization of the collateral used to secure the loan if any, or upon whether the creditor has agreed to look only to the separate property of the debtor for satisfaction of the debt. A debt contracted during marriage is rebuttably presumed to be against the credit of the community and money or other property thereby acquired would therefore probably be community property, unless the creditor agreed to look solely to the separate property of the debtor. Property which is community or separate at the time title is acquired usually remains separate or community under a doctrine known as the “inception of title rule.”
- Many of the rules described herein may be altered by a valid Marital Property Agreement. For example, the Texas Constitution and the Texas Family Code allow spouses to partition and exchange community property, thereby converting it into separate property, and to agree that the income from any of their separate property, then owned or to be acquired, shall be the separate property of the owner.<sup>12</sup> However, by changing the form of property ownership a spouse may be increasing her exposure to creditor claims. For instance, a tort creditor could satisfy a claim against a spouse out of both halves of the community property. If the property is divided, it may be that the property given away or transferred is not available for this purpose. This could definitely work to a spouse’s disadvantage because it could force the spouse into bankruptcy when this otherwise might have been avoided, or at a minimum, it could mean that after satisfying all claims, a spouse may have less disposable property remaining than if the partition had not been made. This is a major disadvantage of a partition.

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<sup>10</sup>*Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.-Dallas 1987, no writ history to date); *Horlock v. Horlock*, 533 S.W.2d 52, 55 (Tex. Civ. App.-Houston [14th Dist.] 1975 writ ref’d n.r.e.); *Carnes v. Meador*, 533 S.W.2d 365 (Tex. Civ. App.-Dallas 1975, writ ref’d n.r.e.); and *Tabassi v. NBC Bank-San Antonio*, 737 S.W.2d 612 (Tex. App.-Austin 1987, no writ history to date). See also 29 Baylor Law Review 608.

<sup>11</sup>Treas. Reg. §25.2511-1(h)(9). *Cox v. U.S.*, 286 F. Supp. 761 (W.D. La, 1968). Cf. *Goodman v. Comm’r*, 156 F.2d 218 (2nd Cir. 1946), and Rev. Rul. 79-303, 1979-2 C.B. 332.

<sup>12</sup>Tex. Const. Art. 16 §15; Tex. Fam. Code §4.103.

- The rules of **marital property liability** can be briefly and partially summarized as follows:
  - A person is personally liable for the acts of the person's spouse only if the spouse acts as an agent for the other spouse, or the spouse incurs a debt for necessities under the duty of support described in Family Code §2.501.<sup>13</sup> A spouse does not act as agent for the other spouse solely because of the marriage relationship.<sup>14</sup>
  - A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are personally liable "by other rules of law."<sup>15</sup> The spouse's separate property and special community property may be liable under Family Code §4.031 for necessities or if the spouse is acting as agent for the other.<sup>16</sup> Each spouse owes a duty of support to the other spouse and to his or her minor children.<sup>17</sup>
  - Unless both spouses are liable under Family Code §4.031 (for necessities or as agent), the community property subject to a spouse's sole management, control and disposition (the spouse's "special community") is not subject to any liabilities of the other spouse incurred before marriage, nor for any nontortious (for example, contractual) liabilities that the other spouse incurs during marriage (at least during life).<sup>18</sup>
  - The community property subject to a spouse's sole or joint management, control and disposition is liable for that spouse's liabilities, whether incurred before or during the marriage.<sup>19</sup>
  - **All community property is liable for torts committed during marriage by either spouse.**<sup>20</sup>

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<sup>13</sup>Tex. Fam. Code §3.201(a)(2).

<sup>14</sup>Tex. Fam. Code §3.201(c).

<sup>15</sup>Tex. Fam. Code §3.202(a).

<sup>16</sup>For an example of a case illustrating that the law is not always what it seems to say, see *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975). It is believed that the rule now found in Fam. Code §4.031 to the effect that a person is liable for the acts of the person's spouse only if acting as agent for the spouse, and that a spouse does not act as agent for the other spouse solely because of the marriage relationship, was passed, in part, in response to *Cockerham*. If the *Cockerham* fact pattern were to arise today, the application of this rule might very well alter the outcome.

<sup>17</sup>Family Code §2.501.

<sup>18</sup>Tex. Fam. Code §3.202(b).

<sup>19</sup>Tex. Fam. Code §3.202(c).

<sup>20</sup>Tex. Fam. Code §3.202(d).

- A spouse's separate property is basically liable to the same extent as a spouse's special community, except with respect to torts committed by the other spouse. A spouse's special community is liable for the torts of the other spouse. A spouse's separate property is not liable for the torts of the other spouse.
- Texas Probate Code §§45 and 156 appear to impose liability on *a decedent's interest* in community property at death, whether or not such property was subject to the decedent's management and control during lifetime. If so, then in some instances death may change the lifetime liability rules contained in Family Code §3.202(b), which, during the life of both spouses, protects a spouse's special community from nontortious liabilities that the other spouse incurs during marriage.
- Assuming the spouses agree, can one spouse's special community be made subject to the sole control and management of the other spouse? Must the property be "mixed" first? Apparently spouses may simply agree, either orally or in writing, that any community property will be subject to the sole control and management of one spouse or the other,<sup>21</sup> in which event, it follows that such property will ordinarily not be subject to the nontortious debts of the noncontrolling spouse.<sup>22</sup> Third parties are, however, entitled to rely upon certain presumptions as to who has control and management.
- "During marriage, property is presumed to be subject to the sole management, control, and disposition of a spouse if it is held in his or her name, as shown by muniment, contract, deposit of funds, or other evidence of ownership, or if it is in his or her possession and is not subject to such evidence of ownership."<sup>23</sup> A third party is entitled to rely on the presumption in the absence of fraud or actual or constructive notice to the contrary.<sup>24</sup>
- Unless otherwise agreed, transactions affecting joint management community property require the joinder of both spouses.<sup>25</sup> The Texas Supreme Court has not yet determined whether one spouse can assign his or her own undivided one-half interest in joint community property without the joinder of the other spouse. The view most consistent with the overall statutory scheme would void such a unilateral attempt as an attempt to

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<sup>21</sup>Tex. Fam. Code §3.102(b) & (c).

<sup>22</sup>See *LeBlanc v. Waller*, 603 S.W.2d 265, 267 (Tex. Civ. App.-Houston [14th Dist.] 1980, no writ.)

<sup>23</sup>Tex. Fam. Code §3.104(a).

<sup>24</sup>Tex. Fam. Code §3.104(b).

<sup>25</sup>See *Baylor Law Review*, Vol. 39:861, page 890.

unilaterally partition; partitions require the joinder of both spouses. The courts of appeals are divided.<sup>26</sup>

- When property is sold, the difference between the sales price and the seller's basis is subject to capital gains tax if the property is sold for a profit. Basis is ordinarily equal to the original purchase price, adjusted for depreciation and capital improvements, perhaps. However, at death, the decedent's basis is increased or decreased to the fair market value of the property at date of death. An interesting feature of community property is that both halves of the property get a new basis at the death of either party to the marriage. **The partition of community property into separate property will therefore cause the loss of a step-up in income tax basis** of the surviving spouse's separate property ownership interest in partitioned property upon the death of the other spouse if the property interest has appreciated in value.
- A divorce court can make an unequal division of community property if it finds such an unequal division to be "just and right" under the circumstances. However, a court's power to award the separate property of one spouse to the other spouse is extremely limited or nonexistent, outside of a spousal support order, **except in the case of quasi-community property**.
- Each spouse is ordinarily free to dispose of that spouse's community property under a properly executed will. However, a testator cannot dispose of the community property interest of the testator's spouse, absent consent.
- An IRA or qualified plan interest may very well constitute community property. If so, the spouse (the nonparticipant spouse) of the IRA or qualified plan owner may be able to dispose of that interest on the death of the nonparticipant spouse. If the qualified plan is subject to ERISA,<sup>27</sup> federal law will preempt the spouse's power of testamentary disposition.<sup>28</sup> ERISA ordinarily will not apply to an IRA, even a rollover IRA, though the Supreme Court has yet to address this issue specifically. Therefore, most attorneys believe that the nonparticipant's community property interest in the participant's IRA will pass to the beneficiaries of the nonparticipant spouse at the spouse's death, in accordance with the nonparticipant's will if there is one, or under the laws of intestate distribution if there is no will.

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<sup>26</sup>*Williams v. Portland State Bank*, 514 S.W.2d 124 (Tex. Civ. App.-Beaumont 1974, writ dismissed); *Vallone v. Miller*, 663 S.W.2d 97 (Tex. App.-Houston [14th Dist.] 1983, writ refused n.r.e.); *Dalton v. Jackson*, 691 S.W.2d 765 (Tex. App.-Austin 1985, writ refused n.r.e.).

<sup>27</sup>The Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001, et seq., as amended.

<sup>28</sup>*Boggs v. Boggs*, 117 S.Ct. 1754, 138 L.Ed.2d 45, 65 U.S. L.W. 4418 (1997).