

A PRIMER FOR ACCOUNTANTS ON THE BASICS OF ARIZONA COMMUNITY PROPERTY LAW

**Howard C. Meyers
Burch & Cracchiolo, P.A.
Phoenix, Arizona**

I. INTRODUCTORY OVERVIEW

Arizona follows a community property schematic and a contrasting sole and separate property schematic with regard to defining property rights and interests by and between husbands and wives. Historically, these concepts are a carryover from Spanish community property law predating the Gadsen Purchase of 1854. As is reflected in IRS Publication 555 (Rev. 12-10) entitled “Community Property”, Arizona is one of only nine (9) community property states, the others being California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

Community property and sole and separate property interests are defined by a series of statutes enacted by the Arizona Legislature. These statutes have in turn been interpreted by the ongoing processes of the trial courts and the appellate courts of Arizona.

The underlying principles of community property and sole and separate property can be readily be stated as “black and white” rules. However, there are many nuances and exceptions which have been judicially developed which have had the effect of complicating any analysis which seeks to ascertain the dividing line between community property and sole and separate property.

There are three basic categories of property:

- (1) community property in which both spouses have an undivided interest;
- (2) the sole and separate property belonging to each spouse; and
- (3) mixed property in which there are interests apportionable to both the marital community and the sole and separate property of one or both

of the spouses (discussed *infra*).

II. THE PRACTICAL CONSEQUENCES OF COMMUNITY PROPERTY LAW FOR THE ACCOUNTING PROFESSION

In many of the day to day aspects of accountancy, the distinctions between community property and sole and separate property are of no particular consequence for either the individual clients or the CPA. For example, if a husband and wife in a community property state file a joint income tax return, there is no need to segregate community income and separate income. However, by way of contrast, if the spouses file separate income tax returns, each spouse must report one-half ($\frac{1}{2}$) of all community income on the separate tax return and all of the filing spouse's sole and separate income.

But in other aspects of individual client engagements, the distinctions between community property and sole and separate property can be critical with regard to the following types of issues:

- (1) Control and decision making related to assets, the transfer or sale of assets, financing and credit transactions, encumbering or hypothecating assets;
- (2) Debtor-creditor issues including, but not limited to, debt collection and personal guaranty issues;
- (3) Tax controversy issues (i.e. the IRS defines an injured spouse as one who files a joint return and all or part of his/her share of an overpayment is applied against the other spouse's past-due obligations to the IRS - such a spouse is entitled to apply for a refund of his or her share of the overpayment applied by the IRS);
- (4) Estate planning, asset protection planning, beneficiary designations operative at death, determination of estate assets for purposes of the preparation of a Form 706, gifting and intestacy running both from and to the spouses; and
- (5) Divorce.

In the fluidity of contemporary domestic relations arrangements, divorce and remarriage by a significant number of individual clients is a given. This makes community property concepts and sole and separate property concepts important to accounting professionals who service and advise individual clients.

Accountants need to be able to help their individual clients spot these types of issues so that they can properly be addressed “before” problems arise. This may involve recommending certain forms of agreements (i.e. prenuptial agreements or the establishment of family limited liability companies by individual clients who have significant assets and are about to enter into new marriages) or considering recommending limitations on personal guaranties where the borrowing is for the benefit of one of the spouse’s sole and separate estate and not for the benefit of the marital community.

Accountants also need to be aware that their work product may in the future come to be offered by one spouse against the other as evidence of the character of certain property as either community property or sole and separate property.¹ Accuracy may dictate either the refinement of certain work product, consultation with other professional advisors of the client (i.e. their estate planning or divorce attorneys) or, in the alternative, proper disclaimers to the effect that the work product is not intended to characterize various items as either community property or sole and separate property.

¹ See, e.g., In re Marriage of Pownall 197 Ariz. 577, 5 P.3d 911 (App. Div.1 2000). “When the parties refinanced a loan on the pizza businesses, Husband's accountant included Wife as a co-applicant and listed both parties' incomes on the personal financial statement submitted to the lender. The accountant also listed the residence and the pizza businesses as joint assets. However, the accountant testified that she did not intend for that designation to constitute an apportionment of the parties' rights in those assets. We find that the accountant's characterization of the property does not establish that the parties intended to acquire and hold that property jointly.”

III. THE KEY STATUTES

A. A.R.S. § 25-211: EVERYTHING IS COMMUNITY PROPERTY “EXCEPT”

“§ 25-211. Property acquired during marriage as community property; exceptions; effect of service of a petition

A. All property acquired by either husband or wife during the marriage is the community property of the husband and wife **except** for property that is:

1. **Acquired by gift, devise or descent.**

2. Acquired after service of a petition for dissolution of marriage, legal separation or annulment if the petition results in a decree of dissolution of marriage, legal separation or annulment.

B. Notwithstanding subsection A, paragraph 2, service of a petition for dissolution of marriage, legal separation or annulment does not:

1. Alter the status of preexisting community property.

2. Change the status of community property used to acquire new property or the status of that new property as community property.

3. Alter the duties and rights of either spouse with respect to the management of community property except as prescribed pursuant to § 25-315, subsection A, paragraph 1, subdivision (a).” (Emphasis added).

The following subsidiary principles apply:

1. When property is acquired by one spouse during marriage, it is presumed to be community property even if titled only in that spouse’s name. Davis v. Davis, 9 Ariz.App. 49, 449 P.2d 66 (App. 1969).

2. Where community property and separate property are commingled, the entire fund is presumed to be community property unless separate property can be explicitly traced. Cooper v. Cooper, 130 Ariz. 257, 635 P.2d 850 (1981).

3. Where title to real property is taken in names of both husband and wife, even though source of funds for purchase of property is the separate property of one spouse, a presumption arises that parties intended to own the property as community property. Noble v. Noble, 26 Ariz.App. 89, 546 P.2d 358 (App. Div.1 1976).

4. When the community contributes capital to separate property, it acquires an equitable lien against that property. See Tester v. Tester, 123 Ariz. 41, 43, 597 P.2d 194, 196 (App.1979) ("The community is entitled to reimbursement when community funds are spent to increase one spouse's equity in separate property."); see also Honnas v. Honnas, 133 Ariz. 39, 40, 648 P.2d 1045, 1046 (1982).

4. If sole and separate property is acquired during marriage, it is advisable to obtain a disclaimer from the other spouse to rebut the community property presumption. Married couples are free to determine the status of their property and their agreements constitute a binding contract that must be enforced in the absence of fraud or mistake. See, e.g., Bell-Kilbourn v. Bell-Kilbourn, 216 Ariz. 521, 169 P.3d 111 (Ariz.App. Div. 1 2007) (a valid disclaimer deed rebuts the presumption that property acquired during marriage is community property).

5. It is well-established in Arizona that pension rights are generally viewed as a form of deferred compensation for services rendered by employees" and that pension rights earned by the community effort of a spouse during marriage are community property subject to equitable division. Thus, even if the employee spouse is not yet entitled to a pension, he and therefore the community acquires a property right in pension benefits even if the rights have not vested, that is subject to division upon dissolution. It is important, however, to distinguish between mature pension rights, which can be more easily valued, and rights that have not yet matured and will not do so for many years.

B. A.R.S. § 25-213: SEPARATE PROPERTY DEFINED

“§ 25-213. Separate property

A. A spouse's real and personal property that is owned by that spouse

before marriage and that is acquired by that spouse during the marriage by gift, devise or descent, and **the increase, rents, issues and profits of that property, is the separate property of that spouse.**

B. Property that is acquired by a spouse after service of a petition for dissolution of marriage, legal separation or annulment is also the separate property of that spouse if the petition results in a decree of dissolution of marriage, legal separation or annulment.

C. Notwithstanding subsection B of this section and § 25-214, subsection C, a mortgage or deed of trust executed by a spouse who acquires the real property encumbered by that mortgage or deed of trust after service of a petition for dissolution of marriage, legal separation or annulment shall be enforceable against the real property if the petition does not result in a decree of dissolution of marriage, legal separation or annulment.

D. A contribution to an irrevocable trust that has or will have as its principal asset life insurance on the person making the contribution is a contribution of the insured's separate property if the spouse of the insured is the primary beneficiary of the trust.”

The following subsidiary principles apply:

1. Just because a business is a premarital sole and separate asset of one of the spouses, do not presume that it is totally immune from the other spouse's community property claim in the event of a divorce. Arizona courts have long agreed that the results of a spouse's labor are community property. Koelsch v. Koelsch, 148 Ariz. 176, 181, 713 P.2d 1234, 1239 (1986) (“[I]t is established law that ... the fruits of labor expended during marriage are community property”). In resolving the specific issue regarding separate property profits and increase in value, Arizona courts have looked to the nature, or source, of the profit from or increase of the separate property business. Cockrill v. Cockrill, 124 Ariz. 50, 53, 601 P.2d 1334, 1337 (1979); Rundle v. Winters, 38 Ariz. 239, 245, 298 P. 929, 931 (1931). The rule is that if the profits and/or increase result from the "inherent qualities of the business," the profits and increase are separate property; if the profits and/or increase result from the "individual toil and application of the spouse," they are community property. Rundle, 38 Ariz. at 245, 298 P. at 931.

2. As stated by the Arizona Court of Appeals:

“In essence, **our community property laws transform the community into an equity partner with the sole and separate property-owning spouse** to the extent the community's efforts have generated net earnings, increased the value, or otherwise increased the net worth and/or market value of the company....The community's share is not eliminated just because the laboring spouse has been paid a fair salary along the way. Rueschenberg v. Rueschenberg, 219 Ariz. 249, 196 P.3d 852, 860 (Ariz.App. Div. 1 2008). (Emphasis added).

C. A.R.S. § 25-214: MANAGEMENT AND CONTROL OF COMMUNITY AND SOLE AND SEPARATE PROPERTY

“§ 25-214. Management and control

A. Each spouse has the sole management, control and disposition rights of each spouse's separate property.

B. The spouses have equal management, control and disposition rights over their community property and have equal power to bind the community.

C. Either spouse separately may acquire, manage, control or dispose of community property or bind the community, except that joinder of both spouses is required in any of the following cases:

1. Any transaction for the acquisition, disposition or encumbrance of an interest in real property other than an unpatented mining claim or a lease of less than one year.

2. Any transaction of guaranty, indemnity or suretyship.

3. To bind the community, irrespective of any person's intent with respect to that binder, after service of a petition for dissolution of marriage, legal separation or annulment if the petition results in a decree of dissolution of marriage, legal separation or annulment.” (Emphasis added).

D. A.R.S. § 25-215: APPORTIONING LIABILITY

“§ 25-215. Liability of community property and separate property for

community and separate debts

A. The **separate property of a spouse shall not be liable for the separate debts or obligations of the other spouse**, absent agreement of the property owner to the contrary.

B. **The community property is liable for the premarital separate debts** or other liabilities of a spouse, incurred after September 1, 1973 but **only to the extent of the value of that spouse's contribution to the community property** which would have been such spouse's separate property if single.

C. The community property is liable for a spouse's debts incurred outside of this state during the marriage which would have been community debts if incurred in this state.

D. Except as prohibited in § 25-214, either spouse may contract debts and otherwise act for the benefit of the community. **In an action on such a debt or obligation the spouses shall be sued jointly and the debt or obligation shall be satisfied: first, from the community property, and second, from the separate property of the spouse contracting the debt or obligation.**”(Emphasis added).

E. **A.R.S. §§ 25-217 AND 25-318 : INTERSTATE ISSUES - PROPERTY ACQUIRED WITHIN ARIZONA AND WITHOUT ARIZONA SUBJECT TO ARIZONA LAW IF THE COUPLE ENDS UP RESIDING IN ARIZONA AND GETS DIVORCED HERE**

“§ 25-217. Ownership of property acquired after moving into state

Marital rights in property which is acquired in this state during marriage by persons married without the state **who move into the state** shall be controlled by the laws of this state.” (Emphasis added).

“§ 25-318. Disposition of property; retroactivity; notice to creditors; assignment of debts; contempt of court

A. **In a proceeding for dissolution of the marriage, or for legal separation**, or in a proceeding for disposition of property following

dissolution of the marriage by a court which previously lacked personal jurisdiction over the absent spouse or previously lacked jurisdiction to dispose of the property, the court shall assign each spouse's sole and separate property to such spouse. It shall also divide the community, joint tenancy and other property held in common equitably, though not necessarily in kind, without regard to marital misconduct. **For the purposes of this section only, property acquired by either spouse outside this state shall be deemed to be community property if the property would have been community property if acquired in this state.....**" (Emphasis added)

F. MISCELLANEOUS STATUTES TO CONSIDER

"§ 33-451. Conveyance of separate property

Married persons of the age of eighteen years or more may convey their separate property without being joined by the spouse in the conveyance." (Emphasis added).

"§ 33-452. Conveyance of community property

A conveyance or incumbrance of community property is **not valid unless executed and acknowledged by both husband and wife**, except unpatented mining claims which may be conveyed or incumbered by the spouse having the title or right of possession without the other spouse joining in the conveyance or incumbrance." (Emphasis added).

"§ 43-562. Husband and wife, liability for tax

The spouse who controls the disposition of or who receives or spends community income as well as the spouse who is taxable on such income is liable for the payment of the taxes imposed by this title on such income. **If a joint return is filed, the liability for the tax on the aggregate income is joint and several.**" (Emphasis added).