

FROM “PRENUPS” TO “PORTABILITY” – A FRESH LOOK
AT MARITAL PROPERTY PLANNING

Thomas M. Featherston, Jr.
Mills Cox Professor of Law
Baylor University
School of Law
Waco, Texas

South Texas College of Law
26th Annual Wills and Probate Institute
September 22-23, 2011

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	KEY MARITAL PROPERTY CONCEPTS	1
A.	The Community Presumption	1
B.	Community Claims for Reimbursement	1
C.	Special Community Property	1
D.	Managing Spouse as Trustee.....	2
E.	Marital Liabilities.....	2
F.	Death of a Spouse.....	2
G.	Death of Claimant Spouse.....	2
H.	Claimant as the Surviving Spouse.....	3
I.	Closing the Estate.....	3
III.	SO, YOUR CLIENT SAYS, “I’M GETTING MARRIED” . . .	4
A.	Existing Assets	4
B.	Future Acquisitions	4
C.	Unilateral Gifts/”Fraud”	4
D.	Debts.....	4
E.	Divorce	4
F.	Death of First Spouse	4
G.	Reimbursement Issues.....	5
H.	To He_ _ (Double Hockey Sticks) With This!.....	5
IV.	SO, ANOTHER CLIENT SAYS, “I’M MOVING TO TEXAS” . . .	5
A.	Existing Assets	5
B.	Future Acquisitions	5
C.	Unilateral Gifts/”Fraud”	5
D.	Debts.....	5
E.	Divorce	6
F.	Death of First Spouse	6
G.	Reimbursement Issues.....	6
H.	To He_ _ (Double Hockey Sticks) With This!.....	6
V.	THE ABSENCE OF A “PRE-NUP”	6
A.	Segregated Accounts	6
B.	Avoid Inadvertent Commingling	7
C.	Separate Investments.....	7
D.	Family Entities	7
E.	Asset Protection Trusts.....	7
F.	Fraud on the Community/Reimbursement Issues	8
G.	Legal Fees	8
VI.	PREMARITAL AGREEMENTS – FORMALITIES.....	8
A.	Uniform Premarital Agreement Act.....	8
B.	Formalities.....	8
C.	Burden of Proof.....	8
D.	The Opponent’s Burden	9
E.	Statute of Limitations	10
F.	Disclosure/Assistance of Counsel	10

VII.	PREMARITAL AGREEMENTS – SUBSTANCE	10
A.	Mere Agreement Rule	10
B.	Constitutional Amendments	11
C.	Sec. 4.003, Texas Family Code	11
D.	Standard Provisions	11
E.	Income from Separate Property	12
F.	Wages, Salaries, Personal Earnings	12
G.	Partition and Exchange	12
H.	Community Free Marriage	13
I.	Division of Property Upon Divorce	14
J.	Contracts Concerning Succession	14
K.	Homestead, Exempt Personal Property and Allowances	15
L.	The Universal Community	15
VIII.	AGREEMENTS DURING MARRIAGE	16
A.	2003 and 2005 Legislation	16
B.	Formalities	17
C.	Transmutation	18
IX.	EFFECTIVENESS OF THE AGREEMENT	19
A.	Necessaries	20
B.	Child Support	20
C.	Tax Liability	20
D.	Spousal Torts	20
E.	Joint Ventures	20
F.	Preexisting Creditors	20
G.	U.F.T.A. and the Bankruptcy Code	20
H.	Federal Preemption	21
I.	Trap for the Unwary	21
J.	Maintenance	21
K.	Future Legislative Changes	21
L.	Income Tax Basis	22
X.	FAMILY BUSINESS PLANNING	22
A.	Entity Theory	22
B.	Distributed Profits	22
C.	Comparison to Corporations	23
D.	Corporate Veil Piercing	23
E.	Convert Sole Proprietorships	24
F.	Partnership Formation	24
XI.	AVOIDING PROBATE –NONPROBATE TO THE SURVIVING SPOUSE	24
A.	Inter Vivos Gift	25
B.	Partition	25
C.	Income Agreement	25
D.	Life Insurance	25
E.	Employee Benefits and Other Retirement Accounts	25
F.	Sec. 450 of the Texas Probate Code	25
G.	C.P.W.R.O.S.	25
H.	Amendments to the Texas Probate Code	26

I.	<i>Holmes v. Beatty</i>	26
J.	Choice of Laws.....	27
K.	Portability	27
XII.	LOST PLANNING OPPORTUNITY.....	28
A.	Non-Tax Advantages.....	28
B.	Tax Advantages.....	28
C.	Terms of the Credit Shelter Trust.....	28
D.	Comparing Portability Planning.....	28
E.	Larger Estates/QTIP Trusts.....	29
F.	Revocable Trust or Will	29
XIII.	NON-PRO RATA DIVISION	29
A.	Executor’s Authority	29
B.	Election Planning	29
C.	I.R.S. POSITION	30
D.	The Law.....	30
E.	The California Approach.....	31
F.	Compare Texas Law.....	31
G.	The Revocable Trust Advantage.....	32
XIV.	COMMUNITY PROPERTY IN THE REVOCABLE TRUST.....	32
A.	Creation and Funding	32
B.	Distributions	33
C.	Power of Revocation	33
D.	Subsequent Incapacity of a Settlor	34
E.	Effect of Divorce.....	34
F.	Death of First Spouse	36
G.	Survivor’s Interests	36
H.	Amending the Survivor’s Trust.....	36
I.	Planning Considerations.....	36
J.	Community Property Basis	37
XV.	THE HOMESTEAD IN TRUST.....	37
A.	Probate Homestead.....	37
B.	Right of Occupancy.....	37
C.	Creditor’s Rights	38
D.	Exempt Personal Property.....	39
E.	Family Allowance	39
XVI.	PLANNING FOR DESCENDANTS.....	39
XVII.	MEDICAID PLANNING?.....	41

I. INTRODUCTION

Going into a marriage and during the early stages of a marriage, a client may be more interested in protecting the client’s “estate” from the significant other (and/or the significant other’s creditors and successors) than planning for the benefit of the significant other. The client’s perception of the “estate” is likely to include not only what the client brings into the marriage and that what is acquired during the marriage by “gift, devise or descent,” but also what those assets generate during the marriage (gains, rents, dividends, interest, etc.). The client may even consider the client’s compensation during the marriage (whether in the form of salary, bonus, contributions to retirement plans and other fringe benefits) to be part of the “estate” in need of asset protection.

Later in the marriage, the client’s focus may shift to planning for the surviving spouse. Providing for the surviving spouse and the client’s descendants (who may or may not be descendants of the spouse) may be just as, if not more, important than protecting the “estate.”

Changing tax laws and developing planning techniques have led to new and creative planning strategies – two of which are mentioned in this paper’s title. The purpose of this paper is to take a “fresh” look at marital property planning in Texas, and the best place to begin is a review of the “default rules” (i.e., what happens in the absence of planning).

II. KEY MARITAL PROPERTY CONCEPTS

An understanding of the characterization/reimbursement rules, the management/liability rules and the termination/dissolution rules are essential to marital property planning, either prior to or during the marriage. However, a detailed discussion of those rules is beyond the scope

of this paper, but there are nine key concepts that should be in the “back of the planner’s mind” and perhaps explained to the client during the planning process.

A. The Community Presumption

Generally, all assets of the spouses on hand during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (e.g., a spouse, or that spouse’s personal representative, or the heirs/devisees of the spouse) asserting separate character to show by “clear and convincing evidence” that a particular asset is, in fact, separate. Tex. Fam. Code §§ 3.001, 3.003.

B. Community Claims for Reimbursement

Reimbursement between the marital estates usually arises when one spouse’s separate property is improved through the expenditure of community funds. Reimbursement may also be applicable if separate funds are expended to benefit community property. In addition, the expenditure of community time, talent and labor in excess of what is necessary to reasonably manage one’s separate property can give rise to a community claim for reimbursement to the extent that excess time, talent or labor is not compensated. Another common reimbursement situation is where one spouse owns separately an insurance policy on that spouse’s life and uses community property to pay the premiums, and upon the insured spouse’s death, the proceeds are payable to a third party. Tex. Fam. Code §§ 3.401 – 3.410.

C. Special Community Property

The term “special community property” was originally defined by Texas courts as that portion of the community estate which was under the wife’s exclusive

control and not liable for the husband’s debts following the landmark decision of *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925), where the Texas Supreme Court held that the legislature could not define the rents and revenue from the wife’s separate property as her separate property, but could exempt those assets, her “special community property,” from his debts. *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963). Today, it is common practice to refer to the community assets subject to either spouse’s “sole management, control and disposition” under Section 3.102(a) as his or her “special community property.”

D. Managing Spouse as Trustee

In *Arnold v. Leonard*, *supra*, the Court explained “. . . that the statutes empowering the husband to manage the . . . community assets made the husband essentially a trustee, accountable as such to the . . . community.” See also *Howard v. Commonwealth Building and Loan Assn.*, 94 S.W.2d 144 (Tex. 1936), where the court explained that, where title to a community asset is held in one spouse’s name, that spouse has legal title and the other has equitable title, explaining: “That one in whose name the title is conveyed holds as trustee for the other. *Patty v. Middleton*, 82 Tex. 586, 17 S.W. 909 (Tex. 1891).” A breach of that fiduciary duty will likely result in a “fraud on the community” claim when the marriage terminates. See Tex. Fam. Code § 7.009.

E. Marital Liabilities

The Texas Family Code creates an “in rem” system of marital property liability. Tex. Fam. Code §§ 3.201 – 3.203. A spouse’s separate property and special community property, as well as the joint community property, are liable for that spouse’s debts during the marriage. If the liability is a tort debt incurred during the

marriage, the other spouse’s special community property is also liable for the debt (the other spouse’s separate property is exempt).

If the debt is not a tort debt incurred during the marriage, the other spouse’s separate property and special community property are exempt during the marriage from the debt unless the other spouse is personally liable under other rules of law. In which event, the other spouse’s property (i.e., that spouse’s special community and separate) is liable as well.

Note: *The marriage relationship, in and to itself, does not make one spouse personally liable for the debts of the other spouse. Tex. Fam. Code § 3.201.*

F. Death of a Spouse

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Nonprobate assets pass to the designated beneficiaries. Tex. Prob. Code § 450. Death works a legal partition of the community probate assets; the deceased spouse’s undivided one-half interest passes to his heirs and/or devisees, and the surviving spouse retains her undivided one-half interest therein. Tex. Prob. Code § 37. A spouse’s testamentary power is generally limited to that spouse’s separate property and undivided one-half interest in the community property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917).

G. Death of Claimant Spouse

Upon the death of the spouse who has a reimbursement claim or claim for fraud on the community against the surviving spouse, the claimant spouse’s one-half interest in the claim passes to that spouse’s heirs or devisees.

1. DUTY OF PERSONAL REPRESENTATIVE

If the heir or devisee is not the other spouse (or if the estate is insolvent), the personal representative has a duty to pursue the claim against the surviving spouse.

2. LIQUIDITY PROBLEMS

The existence of the claim may result in a much larger estate than had been anticipated. The deceased spouse's interest in the claim is included in the deceased spouse's gross estate for estate tax purposes and may cause an immediate liquidity problem.

3. CONFLICT OF INTERESTS

The existence of the claim may create a conflict of interest for both the personal representative and the attorney who are attempting to represent the entire family.

H. Claimant as the Surviving Spouse

Upon the death of the other spouse, the asset which is the subject of the community claim for reimbursement will remain the owner's separate property and pass under the owner's will or by intestate succession; however, the claim of the surviving spouse continues to exist, as does any claim that the deceased spouse committed a fraud on the community or attempted to unilaterally transfer joint community property prior to death.

1. CONFLICT OF INTERESTS

Either situation can create a conflict of interest (i) between the surviving spouse and the decedent's heirs or devisees or (ii) between the heirs or devisees where the heirs or devisees of the separate property are not the same as the heirs or devisees of the community property. This potential conflict can be

particularly troublesome for the personal representative or attorney who attempts to represent all members of the family.

2. ELECTION

The doctrine of equitable election may force the surviving spouse to (i) assert the claim and waive any and all benefits under the will or (ii) accept the benefits conferred in the will and forego the claim. The doctrine of equitable election is applied where any devisee receives a benefit and suffers a detriment in a will. Accordingly, the election concept might work against any party involved.

3. OTHER PROBLEMS

The existence of such a claim with an uncertain value is likely to delay the administration of the estate and create liquidity problems.

I. Closing the Estate

Upon the death of the first spouse and while record legal title still reflects that some community assets are held in the decedent's name, some are held in the survivor's name and others are held in both names, the surviving spouse and the heirs and/or devisees of the deceased spouse are, in effect, tenants in common as to each and every community probate asset, unless the surviving spouse is the sole distributee of some or all of the deceased spouse's one-half interest in such assets. When administration is completed, the survivor and the distributees are generally entitled to their respective one-half interests in each and every remaining community probate asset. Tex. Prob. Code § 37.

III. SO, YOUR CLIENT SAYS, “I’M GETTING MARRIED” . . .

. . . and asks about the effect marriage is going to have on the client’s “estate.” The first response may be that, even absent effective planning, any property the client owned before marriage can (not necessarily will) remain his or her separate property.

A. Existing Assets

Generally, as soon as the couple gets married, each and every item of property will be presumed to be community property. Each traceable asset acquired prior to marriage, as well as any property acquired during the marriage as separate property (e.g., a gift or inheritance), can remain the client’s separate property, if the community property presumption can be overcome by clear and convincing evidence. See II, A, *supra*.

B. Future Acquisitions

However, the spouses’ respective salaries and other forms of compensation (i.e., employer contributions to retirement plans) will be community property. The income being generated by their respective separate properties will be community property. Any other assets purchased by either spouse will be presumed community property unless proven to be separate property (i.e., traceable to existing separate property). Tex. Fam. Code §§ 3.001 - 3.002.

C. Unilateral Gifts/“Fraud”

In addition, the client needs to understand that any unilateral gifts (inter vivos or nonprobate) of the client’s special community property by the client to a child, a child by a prior marriage, or other third party may later be found by a probate or divorce court to have been a breach of a duty owing by the donor spouse to the other

spouse and a “fraud on the community.” See II, D, *supra*.

Note: *A unilateral attempt to transfer joint community property may be void as a matter of law. See Tex. Fam. Code § 3.102.*

D. Debts

Further, if the spouse incurs a tort debt, the creditor may be able to enforce any resulting judgment against any and all community property, even if the client did not have personal liability for the debt, and the creditor gets to take advantage of the community presumption. A breach of contract claim exposes the client’s one-half interest in the joint community and spouse’s special community to liability as well. See II, E, *supra*.

E. Divorce

Generally, community property is subject to an equitable division by the divorce court and separate property is not. See Tex. Fam. Code § 7.001.

Note: *While contractual alimony can be incorporated into a divorce decree, absent such an agreement, the Texas divorce court cannot award alimony to a spouse. Alimony is contrary to Texas public policy. A limited form of alimony, “maintenance,” is available in certain defined situations. See Tex. Fam. Code §§ 8.001 – 8.059.*

F. Death of First Spouse

Upon the first spouse’s death, the deceased spouse will only have testamentary power over the decedent’s separate property and one-half of the community property. The surviving spouse can retain his or her own separate property and one-half of the community after the deceased spouse’s debts are paid. See II, F, *supra*. The surviving spouse may have homestead rights

and/or rights to an “allowance” or to certain exempt personal property.

G. Reimbursement Issues

Whether the marriage eventually terminates in death or divorce, its dissolution will be even more complicated due to the possibility of reimbursement issues accruing during the marriage and maturing upon its termination. See II, B, and II, D, *supra*.

H. To He__ (Double Hockey Sticks) With This!

In view of all of these new complications, the client may wish to “opt out” of the Texas community property regime, a result that can be accomplished in a well-crafted pre-marital agreement. Through such an agreement, parties intending to marry can agree to create a “community free” marriage where all property is the separate property of one spouse or both spouses and eliminate other spousal rights. See XIII, XIV, XV and XVI, *infra*.

IV. SO, ANOTHER CLIENT SAYS, “I’M MOVING TO TEXAS” . . .

. . . and the Texas lawyer is contacted by a non-resident client who is married and moving to Texas (or who has just moved) and who wants to understand the effect the move will have on marital property rights.

Note: *If the couple is moving to Texas from another community property state, do not assume that state’s marital property laws are the same as Texas’. For example, income from separate property is separate property in California.*

A. Existing Assets

Generally, as soon as the couple moves to Texas, each and every item of personal property will be presumed to be community property. Each traceable asset acquired prior to marriage can remain as a spouse’s separate property assuming the recently attached community property presumption can be overcome by clear and convincing evidence. Ownership of any real property generally will be determined by the law of the situs state.

B. Future Acquisitions

However, the spouses’ respective salaries and other forms of compensation (i.e., employer contributions to retirement plans) will be community property. The income being generated by their respective separate properties will be community property. Any other assets purchased by either spouse will be presumed community property unless proven to be separate property (i.e., traceable to existing separate property). Property traceable to property acquired by gift, devise or descent can maintain its separate character.

C. Unilateral Gifts/”Fraud”

Any unilateral gifts (inter vivos or nonprobate) of special community property by a spouse to a child, a child by a prior marriage, or other third party may later be found by a probate or divorce court to have been a breach of a duty owing by the donor spouse to the other spouse and a “fraud on the community.”

D. Debts

Further, if a spouse incurs a tort debt, the creditor may be able to enforce any resulting judgment against any and all community property, even if the other spouse did not have personal liability for the debts, and the creditor gets to take advantage of the community presumption. A breach of

contract claim by one spouse will expose parts of the other spouse’s interest in the community to liability as well.

E. Divorce

Generally, community property is subject to an equitable division by the divorce court and separate property is not. See Tex. Fam. Code § 7.001. However, any separate property that had been acquired while they were residing in the common law state but what would have been community property had they been living in Texas (“quasi-community property”) will be treated as if it were community property and subject to an equitable division by the divorce court. See Tex. Fam. Code § 7.002.

Note: While contractual alimony can be incorporated into a divorce decree, absent such an agreement, the Texas divorce court cannot award alimony to a spouse. Alimony is contrary to Texas public policy. A limited form of alimony, “maintenance,” is available in certain defined situations. See Tex. Fam. Code §§ 8.001 - 8.059.

F. Death of First Spouse

Upon the first spouse’s death, the deceased spouse will only have testamentary power over the decedent’s separate property and one-half of the community property. The surviving spouse can retain his or her own separate property and one-half of the community after the deceased spouse’s debts are paid. Texas does not recognize “quasi-community property” at death. See *Hanau v. Hanau*, 730 S.W. 2d 663 (Tex. 1987). The surviving spouse may have homestead rights and/or rights to an “allowance” or to certain exempt personal property under Texas law, but probably lost any statutory rights granted by the other state.

G. Reimbursement Issues

Whether the marriage eventually terminates in death or divorce, its dissolution will be even more complicated due to the possibility of reimbursement issues accruing during the marriage and maturing upon its termination.

H. To He__ (Double Hockey Sticks) With This!

In view of all of these new complications, the couple may wish to “opt out” of the Texas community property regime, a result that can be accomplished in a well-crafted marital agreement. Through such an agreement, parties moving to marry can agree to create a “community free” Texas marriage where all property is the separate property of one spouse or both spouses and eliminate other spousal rights. See XIII, XIV, XV and XVI, *infra*.

V. THE ABSENCE OF A “PRE-NUP”

Whether or not the Texas client intending to marry trusts the “significant other,” the client unilaterally can take steps prior to the marriage to minimize the complications of a community property marriage and to maintain the separate character of the client’s separate property.

A. Segregated Accounts

At a minimum, the client should be advised to “keep separate, separate” by maintaining existing assets in the client’s name and opening bank and brokerage accounts in the client’s individual name (perhaps with a designation “separate account”) and only depositing into the accounts separate property. Contemporaneous business records showing the source of any and all separate deposits should be retained in the event proof of separate character of the account is later needed.

Note: The creation and funding of a revocable trust prior to marriage may be an effective way to maintain the separate character of the settlor’s assets

B. Avoid Inadvertent Commingling

In a state like Texas, where income from separate property is community property, any interest (or other income generated by the account) should be paid into a different account in the client’s name (perhaps with a designation of “special community account”) in order to avoid a “commingling” of community and separate funds in the separate account. If an account is “commingled,” the account becomes community property.

C. Separate Investments

Any future gift or inheritance and property purchased with funds in any “separate account” or certificates issued out of a separate account, should be held in the client’s name only. Further, real estate should be conveyed to the client “as separate property.” Again, contemporaneous business records can serve as evidence of the nature of the transaction and the separate character of the asset and should be retained.

D. Family Entities

If the client is to be a partner in a family partnership, a member in a family-oriented limited liability company or a shareholder in a closely-held corporation, the client’s interest should be given to the client as a gift (or purchased by the client with traceable separate property). Again contemporaneous business records of the nature of the transaction should be retained. If the client expends any “time, talent or labor” in the management of the entity, paying a reasonable compensation for those personal services can hopefully avoid a later reimbursement claim by the client’s spouse. See X, *infra*.

Note: Prior to the marriage, the client may want to consider creating an entity, like a family limited partnership, and exchange some portion of the client’s estate for interests in the partnership. The partnership interest remains the client’s separate property; the assets of the partnership should be treated as partnership assets if the partnership is properly administered. Paying a reasonable salary for services rendered should avoid Jensen claims. Not making community contributions during the marriage can avoid reimbursement and fraud on the community claims.

E. Asset Protection Trusts

Any and all of future inter vivos or testamentary gifts to the client by others could be placed by the donor in an asset protection trust for the client’s benefit. The spendthrift provisions will help not only insulate the interest from the claims of the client’s creditors, but also any community property claims of the spouse, the spouse’s successors or creditors. Including a statement in the trust agreement that it is the settlor’s intent that any and all interests of the client, as well as any and all distributions of the trust, are separate property may not be conclusive, but may prove to be persuasive in future litigation. Limiting distributions of income and/or principal to an ascertainable standard (health, education, maintenance, or support) is especially important if the client is going to be the trustee or is going to be given general power of appointment. If a third party is going to serve as trustee, income distributions to the client could be at the discretion of the trustee or pursuant to an ascertainable standard. Caution should be exercised in granting any other powers to the client over the trustee or the trust estate. Carefully planning, drafting and administering the trust could prove to be persuasive in maintaining the client’s

interests in the trust, as well as distributions from the trust, as separate property.

**F. Fraud on the Community/
Reimbursement Issues**

An understanding of the concepts of “wrongful transfers” and “reimbursement” can minimize the risks that such issues will become material issues when the marriage eventually terminates. See III and V, *supra*. For example, the client can avoid using community property to make improvements to separate property or to make principal and interest payments on indebtedness secured by separate property or to pay the premiums on any separately owned life insurance policies. Gifts to children by a prior marriage and others should be given from separate sources.

G. Legal Fees

Legal fees paid by the client during the marriage for this type of planning should be paid by the client with separate property to avoid any claim by the spouse that the client misused their community property to the spouse’s detriment.

Note: An individual client moving to Texas can be advised to take similar steps!

**VI. PREMARITAL AGREEMENTS –
FORMALITIES**

If the couple is open to pre-marital planning, Texas law permits persons intending to marry to enter into a wide variety of property agreements that can convert into separate property what would otherwise be community property and therefore subject to the claims of certain creditors of both spouses, or subject to division by a divorce court, or partition by a probate court. A spouse’s separate property is generally exempt from the creditors and claims of the other spouse. The ability to

accomplish this result depends initially on satisfying the formality requirements specified in the Uniform Premarital Agreement Act.

**A. Uniform Premarital Agreement
Act**

The 1987 Legislature enacted the Texas version of the Uniform Premarital Agreement Act. It does not appear that the legislation attempted to change what parties intending to marry could accomplish in a premarital agreement since the power to contract in these matters is ultimately controlled by the Texas Constitution, and the 1980 amendment had already significantly expanded the parties’ power to contract. The Uniform Premarital Agreement Act did affect the formal requirements and enforceability of premarital agreements. Among other technical changes, there was a dramatic shift in the burden of proof when the validity of an agreement is placed in question.

B. Formalities

As under prior law, a premarital agreement must be in writing and signed by the parties. It need not be witnessed, acknowledged or sworn to. It is enforceable without consideration. Tex. Fam. Code § 4.002. It becomes effective on marriage. Tex. Fam. Code § 4.004. It can be amended by a written agreement of the parties. Tex. Fam. Code § 4.005.

C. Burden of Proof

Under prior law, the burden of proof was imposed on the party seeking to enforce the agreement to establish by clear and convincing evidence that the other party gave “informed consent” and that the agreement was not obtained by fraud, duress or overreaching. Now, the burden of proof is placed on the party asserting the

agreement’s invalidity. Tex. Fam. Code § 4.006.

D. The Opponent’s Burden

The party opposing the agreement must now prove that (i) the agreement was not entered into voluntarily, or (ii) it was unconscionable when it was executed and the opponent was not provided with a fair and reasonable disclosure of the proponent’s financial situation, or did not waive such disclosure and did not have adequate knowledge of such situation. In other words, there is a statutory presumption of validity.

1. INVOLUNTARINESS

The issue of involuntariness (i) relates to the issue of whether the opponent entered into the agreement “freely” and (ii) incorporates effectively the possible contractual defenses of competency, fraud, misrepresentation, duress and coercion as evidenced by the terms of the agreement or the surrounding facts and circumstances. Other relevant factors may be the opponent’s understanding of the agreement at the time it was executed and whether the opponent had adequate time to consider the terms of the agreement prior to execution. See Fullenweider and Rainey, “Litigating Premarital Agreements,” Advanced Family Law Course, State Bar of Texas (1988).

2. UNCONSCIONABILITY

Section 4.006(b) of the Texas Family Code provides that the issue of unconscionability is a question of law to be decided by the court, not the jury. The relevant factors for the court to consider may include the negotiating atmosphere, the relative bargaining abilities of the parties, and over-reaching by a party, as well as the legality of the contract and

whether or not it violates public policy. Fullenweider and Rainey refer to the Uniform Premarital Agreement Act, 9(b) UCA 20, to include factors such as concealment of assets and sharp dealing not consistent with the obligation of marital partners to deal fairly with each other. See Fullenweider, *supra*. However, it is important to remember that, according to Sec. 4.006(b), even an unconscionable agreement can be enforced if it was entered into voluntarily by an opponent who was either provided fair and reasonable disclosure or who waived such disclosure or who did not already have adequate knowledge of the financial situation of the proponent.

3. WAIVER

Generally, in order to be valid, a waiver of a statutory right must be a voluntary and intentional release of the right. It must be clear, specific and unequivocal. The party signing the waiver must have full knowledge of its consequences.

4. FAIRNESS

Notwithstanding the discussion of involuntariness and unconscionability, it is important to remember that there is no requirement that a premarital agreement be fair to be enforced. In *Chiles v. Chiles*, 779 S.W.2d 127 (Tex. App.–Houston [14th Dist.] 1989, writ denied), overruled on other grounds by *Twyman v. Twyman*, 855 S.W.2d 619 (Tex. 1993), the court held: “Parties should be free to execute agreements as they see fit and whether they are ‘fair’ is not material to validity.” Accordingly, Texas law currently appears to require only that a premarital agreement be fairly entered into and not that it be fair in application to both parties.

5. COMMON LAW DEFENSES

In *Daniel v. Daniel*, 779 S.W.2d 110 (Tex. App.–Houston [1st Dist.] 1989, no writ), the court discussed whether old Sec. 5.46’s comparable section for marital agreements, old Sec. 5.55, abolishes common law contract defenses (e.g. such as fraud, duress and competency), and concluded that it did not. However, the predecessor to Sec. 4.006 eliminated the common law defenses for agreements executed on or after September 1, 1993, but they still appear to be incorporated into the concepts of involuntariness or unconscionability.

6. RECENT CASES

In *Sheshunoff v. Sheshunoff*, 172 S.W.3d 686 (Tex. App.–Austin 2005, pet. denied), the court discussed the premise that premarital agreements are presumptively enforceable, even if they are unconscionable, unless they were entered into unfairly. Other courts have followed this presumption that premarital agreements are enforceable. See *Larson v. Prigoff*, 2001 WL 13352 (Tex. App.—Dallas, Jan. 8, 2011).

E. Statute of Limitations

The statute of limitations applicable to any breach of the agreement is tolled until the marriage is terminated. Equitable defenses, such as laches and estoppel, are, however, preserved. Tex. Fam. Code § 4.008.

F. Disclosure/Assistance of Counsel

The law does not require that the parties be represented by separate legal counsel at the time of the agreement; however, the lack of independent counsel representing the party opposing the agreement’s enforcement is likely to be an

important factor in determining an agreement’s enforceability. Failing to fully disclose the client’s financial situation can be problematic even if a waiver of such information is obtained from the other party.

VII. PREMARITAL AGREEMENTS – SUBSTANCE

Prior to 1987, the Texas Family Code granted blanket authority to parties to enter into such agreements as they desired, subject, of course, to the limitations of the Texas Constitution and other public policy concerns. The Uniform Premarital Agreement Act, which includes a laundry list of subjects that can be addressed in a premarital agreement, was adopted in 1987. Today, the parties can still enter into such property agreements as they may desire, but the agreement is still subject to the limitations of the Texas Constitution and certain public policy concerns.

A. Mere Agreement Rule

In 1902 the Texas Supreme Court announced what became known as the mere agreement rule: “The question whether particular property is separate or community must depend upon the existence or nonexistence of the facts, which, by the rules of law, give character to it, and not merely upon the stipulations by the parties that it shall belong to one class or the other.” *Kellet v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902). The net effect of the mere agreement rule is that the constitutional definition of separate property limits the flexibility of spouses and those about to marry in their property agreements.

Note: The mere agreement rule today can be summarized as follows: The provisions of an agreement which attempt to change the character of property in a manner not authorized by Art. XVI, Sec. 15, are void.

B. Constitutional Amendments

The 1948 amendment to Art. XVI, Sec. 15, permitted spouses to partition and exchange presently existing community property. The 1980 amendment to Art. XVI, Sec. 15 authorized the creation of separate property in more ways:

1. PREMARITAL PARTITIONS

Persons intending to marry can partition and exchange community property not yet acquired. See also Tex. Fam. Code § 4.003.

2. SPOUSAL PARTITIONS

Spouses may now partition and exchange not only presently existing community property but also community property not yet in existence into the spouses' separate properties. See also Tex. Fam. Code § 4.102.

3. INCOME FROM SEPARATE PROPERTY

Spouses may also agree that income from one spouse's separate property will be that spouse's separate property. See also Tex. Fam. Code § 4.103.

4. SPOUSAL DONATIONS

A gift by one spouse to the other spouse will be presumed to include the income generated by the donated property so that both the gift and the future income from the gift are the donee spouse's separate property. See also Tex. Fam. Code § 3.005.

The 1999 amendment to Art., XVI, Sec. 15 permitted spouses to convert by agreement separate property into community property beginning on January 1, 2000.

C. Sec. 4.003, Texas Family Code

Currently, parties to a premarital agreement are authorized by statute to contract with respect to:

1. The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located.
2. The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property.
3. The disposition of property on separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event.
4. The modification or elimination of spousal support.
5. The making of a will, trust, or other arrangement to carry out the provisions of the agreement.
6. The ownership rights in and disposition of the death benefit from a life insurance policy.
7. The choice of law governing the construction of the agreement.
8. Any other matter, including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.

D. Standard Provisions

It is common for premarital agreements to simply confirm the status of Texas law. For example, the parties agree

that certain itemized assets brought into the marriage and their mutations are to remain the owner's separate property. They may also confirm that anything acquired during marriage by gift, devise or descent will be separate property. They may even agree that such separate property will not be subject to a just and equitable division at divorce. *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

E. Income from Separate Property

Parties may agree that income from separate property is the owner's separate property. Since the Constitution expressly authorizes only spouses to make such agreements and not persons intending to marry, it may be advisable to draft such an agreement as a partition, since both spouses and persons intending to marry can partition community property not yet in existence (i.e., future income from separate property). Accomplishing this result through a partition, however, may not be necessary since by statute a premarital agreement becomes effective on marriage; thus, spouses are really making the agreement. Tex. Fam. Code § 4.004. On the other hand, why does the Constitution distinguish between parties intending to marry and spouses? See *Fanning v. Fanning*, 828 S.W.2d 135 (Tex. App.–Waco 1992), rev'd in part on other grounds, 847 S.W. 2d 225 (Tex. 1993); *Dokmanovic v. Schwarz*, 880 S.W.2d 272 (Tex. App.–Houston [14th Dist.] 1994, no writ).

F. Wages, Salaries, Personal Earnings

Following the passage of the 1980 amendment practitioners questioned whether the parties to a premarital agreement should be able to agree that wages and salaries and other personal earnings will be the acquiring

spouse's separate property. For example, Professor Sampson noted:

It remains to be seen whether revising the type of agreement entered into here to contemplate a present partition of future earnings will suffice to take the parties completely out of the community property system. Generally, I hope not, although I also tend to believe that folks ought to be able to do what they want with their property. On the other hand, an agreement such as this between a doctor and his to be housewife seems clearly abusive and overreaching. Editor's note, Family Law, State Bar Section Report, Vol. 87-6, Fall 1987, pp. 35-36.

Professor Sampson's comments followed a discussion of *Bradley v. Bradley*, 725 S.W.2d 503 (Tex. App.–Corpus Christi 1987, no writ), where the court held that a particular premarital agreement did not effectively partition the parties' future earnings. It should be noted that the Bradley agreement itself was not drafted to accomplish a direct partition of future earnings, but was an agreement to partition future earnings once the earnings came into existence.

G. Partition and Exchange

Notwithstanding Professor Sampson's initial concerns, Art. XVI, Sec. 15 of the Texas Constitution appears to clearly authorize the partition and exchange of any and all community property not yet in existence, including, but not limited to, personal earnings, retirement benefits, I.R.A.s, trust income, income from separate property, and property acquired on credit; so does the legislature. See Sec/ 4.001(2) of the Texas Family Code. The cases of *Fanning v. Fanning*, *supra*, and *Winger v. Pianka*, 831

S.W.2d 853 (Tex. App.–Austin 1992, writ denied) have confirmed this viewpoint.

H. Community Free Marriage

It is, therefore, the “partition and exchange” agreement which can be effectively used to create the “community free marriage.” By eliminating community property from the marriage, wrongful transfer issues, like “fraud on the community” are also eliminated. This type of agreement also allows the couple to address some otherwise troubling issues.

1. REIMBURSEMENT

If there still exists the possibility of a community claim for reimbursement, it would be advisable to address specifically any such potential claim in the premarital agreement. For example, perhaps the nonowner spouse could agree to waive the claim for reimbursement. *Stoker v. Stoker*, 2008 WL 4837084 (Tex. App.–Houston [1st Dist.] 2008), involved a premarital agreement that waived economic contribution claims by the nonowner spouse. The court held that this was permissible under Tex. Fam. Code § 3.410. However, it may be advisable for the couple to partition the claim in a manner which would at least limit the exposure the owner spouse would have by reason of the community claim for reimbursement.

2. QUASI-COMMUNITY PROPERTY

Separate property acquired by a couple while residing in a common law state that would have been community had they been residing in Texas can be divided by a Texas divorce court on a just and right basis. Tex. Fam. Code § 7.002. The Family Code does not convert such asset into community

property, but allows for it to be treated as such in a divorce proceeding. This concept is not available in probate. See *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Since such property is merely quasi-community and not actually community property, can it be subject to a partition and exchange agreement as authorized by the constitution and the statutes? Is this a right that the nonowner spouse can waive in a premarital agreement? There does not appear to be a good answer to this question, but it is an issue that should be addressed specifically in this agreement, if relevant.

3. QUASI-SEPARATE PROPERTY

A 2003 amendment to Sec. 7.002 treats as separate property any community property that was acquired while the couple resided in another state that would have been separate, had they resided in Texas at the time of its acquisition. Presumably “quasi-separate” property would be treated as community property if the marriage terminates by reason of a spouse’s death, if the reasoning of the *Hanau* case, *supra*, is followed. Since such property is merely quasi-separate and not actually separate property, this category of community property should be subject to a partition and exchange agreement.

4. PROFESSIONAL DEGREES, LICENSES

In view of the trend in some states to treat professional degrees and licenses as property and therefore capable of division by the divorce court and possible partition by the probate court, the possibility of such a result in Texas should be anticipated although the only case in Texas to date on point has held to the contrary. See *O’Brien v. O’Brien*,

489 N.E.2d 712 (N.Y. 1985) and *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. Civ. App.–San Antonio 1980, writ dismissed w.o.j.). If professional degrees and licenses are eventually found to be property in Texas and consequently community property, if acquired during marriage, they should be treated as such in the agreement and could be subjected to a partition and exchange, if the parties so agree.

5. CERTAIN PERSONAL INJURY RECOVERIES

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code § 3.001(a)(3). Notwithstanding this statutory provision and *Graham v. Franco, supra*, the author is of the opinion that actual “lost earnings” should be deemed to be community property, while “loss of earning capacity” should be considered separate property. Lost earnings are properly characterized as community property since the community estate will be liable for payment of medical expenses and will suffer as a result of losing one spouse’s community earnings. However, characterizing the recovery for lost earning capacity as community property requires a presumption that the couple will remain married indefinitely. In reality, should the spouses divorce following the injury, community recoveries will be divided on a just and right basis; or should the non-injured spouse die, the estate will be entitled to one-half of the entire recovery. Since the primary purpose of a personal injury recovery is to compensate the injured spouse, classifying lost earning capacity as community property and giving the non-injured spouse a one-half interest therein

may leave the injured spouse with only a fraction of the amount awarded. The potential for such a situation clearly warrants a distinction between lost earnings and lost earning capacity which characterizes the former as community and the latter as separate. In view of current law possibly creating such an inequitable result, possible personal injury recoveries could be addressed in a partition and exchange agreement.

6. PERSONAL SERVICE CONTRACTS

Wages and salaries earned during the marriage are clearly community property, but the characterization of money earned during the marriage pursuant to a contract signed before marriage, or money received after the marriage pursuant to a deferred compensation agreement signed during the marriage, can be complicated. Even if wages and salaries generally are not going to be partitioned, these other issues could be addressed in the premarital agreement to avoid future confusion and litigation.

I. Division of Property Upon Divorce

The parties should be able to agree as to a certain division of any community and their respective separate properties in the event of divorce instead of awaiting an “equitable division” of the community by the divorce court. Of course, such an agreed to division cannot affect a parent’s child support obligations. Such an agreement may also affect the determination of whether an agreement is unconscionable or not.

J. Contracts Concerning Succession

The parties to a premarital agreement may also agree that they will not assert inheritance rights upon the first spouse’s death or that one spouse is to leave to the

other spouse certain assets in the event the marriage terminates by reason of the obligor's death. Sec. 59A of the Texas Probate Code was amended in 2003 in order to confirm that a contract to make a will or devise can be established by either (i) provisions in a will stating that the contract exists and the material provisions of the contract, or (ii) the provisions of a written agreement that is binding and enforceable. Even without the addition of the latter provision, this author is of the opinion that Sec. 59A was never intended to apply to an agreement whereby a spouse is required to leave property to the other spouse pursuant to a premarital agreement. This situation is not one where there are reciprocal testamentary promises but one where there is current consideration in exchange for a testamentary promise.

K. Homestead, Exempt Personal Property and Allowances

In *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), the Texas Supreme Court approved the provisions of a premarital agreement whereby one party waived his right following the first spouse's death to occupy the other party's separate property home, to utilize the exempt personal property and to claim a family allowance.

1. SELECTION AND ABANDONMENT

The premarital agreement presents the opportunity for a couple to agree which of their homes will be the homestead and what process should be followed to abandon and select a new one.

2. SALE OR ENCUMBRANCE

The *Williams* case involved the surviving spouse's rights following the owner's death. Sec. 5.001 of the Texas Family Code prohibits the owner of the

homestead from selling or encumbering it during the marriage without the joinder of the non-owner spouse. Can this right of the non-owner be waived in a premarital agreement? Sec. 4.003(a)(2) appears to authorize it.

3. LIABILITY

So long as the owner is alive, the homestead and certain items of personal property continue to be exempt from the claims of certain creditors. Tex. Prop. Code §§ 41.001 and 42.002. However, if the non-owner has waived the right of occupancy and possession upon the death of the owner, will such property continue to be exempt from most creditors following the owner's death? Presumably yes, if the owner also was survived by a minor child. But if the only constituent family member surviving the owner is the spouse who previously waived these rights, the answer is not so clear.

Note: Prior to 2005, Texas case law appeared to grant the exemption from creditors if the owner was survived only by an unmarried child living at home. 2005 amendments to Sections 271 and 272 may have inadvertently eliminated that exemption.

L. The Universal Community

Can the parties to a premarital agreement agree that the property they are bringing into the marriage and/or the property to be acquired during marriage by gift, devise or descent are to be community property? In other words, can those intending to marry agree to an "all community" marriage? Notwithstanding the 1999 amendment, such an agreement would still appear to violate the Texas Constitution, which does not expressly offer a procedure for parties intending to marry to accomplish

the result. *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949). Of course, once married, one spouse may give the other spouse one-half of the donor's separate property, thereby making them tenants in common, and spouses over a period of time can allow their separate estates to become commingled and, therefore, community property. In addition, since January 1, 2000, spouses can enter into a transmutation agreement once they are married. Or, is a premarital agreement really a marital agreement?

Note: Some practitioners follow the practice of having the couple re-execute the pre-marital agreement following the wedding, a practice which is not necessary, in the author's opinion, if the original agreement is a properly drafted "partition and exchange agreement." Further, the Texas Family Code states that a pre-marital agreement actually becomes effective upon marriage.

VIII. AGREEMENTS DURING MARRIAGE

During marriage, spouses can generally accomplish the same results that could have been generated in a premarital agreement. They can partition or exchange among themselves their existing community property and any community property to be acquired in the future. Tex. Fam. Code § 4.102. Spouses may also agree that income from a spouse's separate property will be separate property. Tex. Fam. Code § 4.103. Accordingly, spouses, like persons intending to marry, have the legal ability to create a "community free marriage."

A. 2003 and 2005 Legislation

Section 4.102 was amended in 2003 to provide that, if community property is partitioned, the income the partitioned

property thereafter generates is also partitioned into separate property unless the parties agree such income will be community property. HB 885 (2003). However, due to concerns that the 2003 amendment may have been unconstitutional, HB 202 (2005) amended Sec. 4.102 again to negate the presumption that future earnings and income would be separate property so that now Sec. 4.102 only authorizes such an agreement.

Accordingly, the parties to a partition and exchange agreement now have the express statutory authority to partition and exchange the future earnings and income from the property they had agreed to partition, a right already granted to them by the 1980 amendment to Art XVI, Sec. 15 of the Texas Constitution and Sec. 4.102 as originally enacted.

1. PRE-2005 PARTITIONS

Unfortunately, it can be anticipated that someone will argue and perhaps even convince a court that Texas spouses did not have until the effective date of the 2005 amendment the right to partition the future earnings of income of the community property being partitioned, thereby casting doubt on the effectiveness of any such agreements entered into prior to that time. Hopefully, the courts will rule that spouses have had the constitutional right to enter into these types of agreements since November 4, 1980, and that the legislature was not even trying to take this right away in their later legislation. Nevertheless, there also remains the question of the effectiveness of partition and exchange agreements entered into between the effective dates of the 2003 and 2004 amendments that do not expressly divide the future earnings and income of the property being partitioned.

2. PARTITIONS WITHOUT CONSIDERATION

HB 202 (2005) also amended Sec. 4.104 by adding a sentence that provides: “Either agreement (referring to both Sec. 4.103 and Sec. 4.102 agreements) is enforceable without consideration.” This sentence makes sense as applied to Sec. 4.103 agreements but may be unconstitutional as to Sec. 4.102 partition and exchange agreements. A partition and exchange agreement contemplated by Art. XVI, Sec. 15 requires some type of consideration received by both parties to the agreement, otherwise the agreement is, in reality, a gift if one party receives 100% of the property being partitioned.

The court in *Byrnes v. Byrnes*, 19 S.W.3d 556, 559 (Tex. App.–Ft. Worth 2000, no pet.), stated the obvious:

The term “partition” as used in this section contemplates a division of property among the parties, not a complete forfeiture or assignment. See *McBride v. McBride*, 797 S.W.2d 689, 692 (Tex. App.–Houston [14th Dist.] 1990, writ denied). Absent a specific reference to a partition or language indicating that such a division was intended, Texas courts have refused to uphold transactions between spouses as partitions. See *Maple v. Nimitz*, 615 S.W.2d 690 (Tex. 1981); *Collins v. Collins*, 752 S.W.2d 636, 637 (Tex. App.–Ft. Worth 1988, writ ref’d).

Of course, a gift by one spouse to the other of presently existing community property is permissible under Art. XVI, Sec. 15, but that section may not allow such a gift of any and all community property to be acquired in the future. Other than income from separate

property, other future community acquisitions (e.g., future personal earnings) can only be partitioned under Art. XVI, Sec. 15. Of course, a gift of presently existing community property by one spouse to the other is presumed to include any future income generated by the gift. Tex. Fam. Code § 3.005, as authorized by Art. XVI, Sec. 15.

3. FORM OVER SUBSTANCE

This 2005 amendment implies that spouses could “partition” an item of community property so that it becomes one spouse’s separate property. Accordingly, without an express partition of the future income, the future income the partitioned property generates would be community property. However, if one spouse gives to the other spouse an item of community property, the property is the donee spouse’s separate property, and the future income it generates will also be separate property, unless the donor spouse expressly retains a community income interest. Form over substance should not prevail; if a “partition” results in one spouse receiving 100% of the property being “partitioned,” it’s not a partition, but rather, it is a gift. Why create confusion by enacting a statute that says a partition does not need consideration?

B. Formalities

The formalities required and the rules of enforcement for marital agreements are essentially the same as for premarital agreements. Tex. Fam. Code §§ 4.104 and 4.105. On the other hand, these agreements would appear to be particularly susceptible to charges of involuntariness and unconscionability. Further, any such agreement cannot prejudice the rights of

preexisting creditors. Tex. Fam. Code § 4.106.

Note: An agreement in order to settle property rights incident to a divorce requires the approval of the divorce court. Tex. Fam. Code § 7.006. In other words, a divorce settlement cannot be disguised as a marital agreement to avoid court involvement in property division at divorce.

C. Transmutation

Prior to January 1, 2000, it was unconstitutional for a married couple to convert by agreement separate property into community property. Many believed that couples should have that flexibility since they had the ability to convert community into separate by agreement. They already had the ability to allow their separate assets to become commingled and therefore community property. They could also exchange a separate asset for a community asset. So why not allow the conversion of separate into community by agreement? Perhaps a couple would like to take advantage of the "step up in basis" community property enjoys upon the death of one spouse. Perhaps they wish to rescind an earlier agreement to convert community into separate so that property which was community is community again. There are any number of legitimate reasons why a couple should have the ability to change the character of their marital assets from community to separate, or separate to community.

1. CHANGE IN LAW

Accordingly, the 1999 Legislature approved both HB 734 and HJR 36. HB 734 (1999) described a procedure whereby spouses could by agreement change separate property into community property. See Tex. Fam. Code § 4.202. Their ability to utilize this

procedure depended on a constitutional amendment to Art. XVI, Sec. 15 (HJR 36) being approved by the voters in November 1999. It was approved by the voters on November 2, 1999, and became effective January 1, 2000.

2. FORMALITIES

An agreement to convert separate property into community property must be in writing and: (a) be signed by the spouses; (b) identify the property being converted; and (c) specify that the property is being converted into the spouses' community property. Tex. Fam. Code § 4.203.

3. MANAGEMENT

An agreement to convert a spouse's separate property into community does not necessarily mean that the newly created asset is subject to joint management. Management still depends on record title or possession. Tex. Fam. Code § 4.204.

4. ENFORCEABILITY

The agreement is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not: (a) execute the agreement voluntarily; or (b) receive a fair and reasonable disclosure of the legal effect of converting the property into community property. Tex. Fam. Code § 4.205.

5. PRESUMPTION OF FAIR DISCLOSURE

An agreement that contains the following statement, or substantially similar words, prominently displayed in bold-faced type, capital letters, or underlined, is rebuttably presumed to provide a fair and reasonable disclosure of the legal effect of converting property to community property:

This instrument changes property to community property. This may have adverse consequences during marriage and on termination of the marriage by death or divorce. For example:

Exposure to creditors. If you sign this agreement, all or part of the separate property being converted to community property may become subject to the liabilities of your spouse. If you do not sign this agreement, your separate property is generally not subject to the liabilities of your spouse unless you are personally liable under another rule of law.

Loss of management rights. If you sign this agreement, all or part of the separate property being converted to community property may become subject to either the joint management, control and disposition of you and your spouse or the sole management, control and disposition of your spouse alone. In that event, you will lose your management rights over the property. If you do not sign this agreement, you will generally retain those rights.

Loss of property ownership. If you sign this agreement and your marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of your spouse or your spouse’s heirs. If you do not sign this agreement, you generally cannot be deprived of ownership of your separate property upon termination of your marriage, whether by death or divorce.

See Tex. Fam. Code § 4.205(b).

6. PREEXISTING CREDITORS

A conversion of separate property to community property does not affect the rights of a preexisting creditor of the spouse whose separate property is being converted. Tex. Fam. Code § 4.206. After all, a transmutation agreement is a “transfer” of property from one spouse to the other.

IX. **EFFECTIVENESS OF THE AGREEMENT**

Assuming a valid, enforceable agreement has been executed in order to create a “community free marriage,” have the goals of insulating each spouse’s separate estate from the claims of the other spouse and the other spouse’s creditors and successors been accomplished? The answer: “Maybe!”

For one thing, since everything is his or her separate property, each spouse is free generally to manage his or her property without interference from the other spouse. However, absent an effective waiver, the homestead rules will still prohibit a transfer or encumbrance of the home without the joinder of the other spouse.

Further, the separate assets of one spouse are generally exempt from the creditors of the other spouse. In the event of divorce, there is no community property to divide on a just and right basis; and upon the death of a spouse, the decedent’s estate passes to the decedent’s heirs and devisees, and the surviving spouse retains his or her estate untainted by the claims of the decedent’s heirs and devisees.

However, the situation may not be as perfect as it may appear.

A. Necessaries

Generally, each spouse still has the legal duty to support the other spouse and their children for so long as the children are minors and thereafter until they graduate from high school. Tex. Fam. Code §§ 2.501 and 154.001. Therefore, both spouses’ separate properties are liable for such necessities. Tex. Fam. Code § 3.201.

B. Child Support

As would be expected, an agreement between spouses to limit either’s child support obligations would be against public policy. This concept has been codified in Sec. 4.003 of the Texas Family Code.

C. Tax Liability

For any tax year that the spouses file joint income tax returns, each spouse remains jointly and severally liable for any tax liability arising from that year’s tax.

D. Spousal Torts

Will public policy prevent the anticipatory waiver of spousal tort claims in premarital agreement? Should there be a different rule for negligence and intentional torts? In general, see “Releases: An Added Measure of Protection from Liability,” 39 *Baylor L. Rev.* 487 (1987).

E. Joint Ventures

A spouse remains personally liable for the acts of the other spouse if the other spouse is an agent or otherwise innocent spouse. Tex. Fam. Code § 3.201. Although the marital relationship itself does not create a principal/agency relationship among the married couple, their being engaged together in a business venture or other joint action can create vicarious liability and expose each spouse’s separate property to any liability arising therefrom.

F. Preexisting Creditors

Section 4.106 of the Family Code says that a partition and exchange agreement is void with respect to the rights of preexisting creditors whose rights are intended to be defrauded therein. It is interesting to note that it is not clear whether this provision applies to premarital partition and exchange agreements. Also, such provision does not by its own terms apply to spousal income agreements under Sec. 4.102.

G. U.F.T.A. and the Bankruptcy Code

Creditors may avoid and recover fraudulent transfers. The trustee in bankruptcy can avoid transfers deemed fraudulent under the Texas version of the Uniform Fraudulent Transfer Act. This means that certain prepetition transfers of community property by a filing spouse to a nonfiling spouse, by way of gift or partition, can be avoided because the transfer acted to deprive creditors of property that would otherwise be available to creditors as part of the bankruptcy estate. Each type of transfer must be analyzed under the fraudulent transfer theory to determine if assets otherwise within the reach of a creditor have been pulled beyond the creditor’s reach by virtue of the challenged transfer. For example, a spouse might impermissibly transfer his own interest in existing community property by way of a partition. Yet the same spouse could probably renounce, by way of a premarital partition, an interest in community property to be acquired in the future since the parties to the partition had no vested interest in the future community property absent the partition. Of course, these sections of the U.F.T.A. and the Bankruptcy Code also invalidate transfers involving actual or constructive fraud.

H. Federal Preemption

ERISA “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan...” 29 U.S.C.A. Sec. 1144. Further, ERISA requires for many qualified retirement plans that the participant’s spouse receive a mandatory death benefit upon the death of the participant or a joint and survivor annuity upon the retirement of the participant, regardless of the marital property character of the participant’s interest in the plan. Of course, the spouse may waive these statutory rights in a consent procedure described by statute. 29 U.S.C.A. Sec. 1055(c).

Several cases have held that these ERISA granted rights of the participant’s spouse cannot be waived in a premarital agreement. In *Manning v. Hayes*, 212 F.3d. 866 (5th Cir. (Tex.) 2000), cert. denied, 121 S.Ct. 1401 (2001), language in a premarital agreement was not sufficiently explicit to result in a waiver of an ex-wife’s beneficiary status under an ERISA plan. In *Hurwitz v. Sher*, 789 F.Supp. 134 (S.D.N.Y. 1992), aff’d by 982 F.2d. 778 (2nd Cir. 1992), cert. denied 508 U.S. 912 (1995), the decedent and his spouse executed a premarital agreement waiving any rights with respect to the other’s separate property and the court held that the wife had not waived her rights to the plan benefits to which she was entitled because only a spouse, not a fiancé, can waive such rights under federal law. A similar result was reached in *Nellis v. Bowing Co.*, 1992 WL 122773, 15 Employee Benefits Vas. 1651 (D. Kan. 1992); further, the court noted that language in the agreement stating that the agreement was to take effect upon marriage did not save the agreement. In *Zinn v. Donaldson Co.*, 799 F.Supp. 69 (D. Minn. 1992), the court even held that a constructive trust could not be imposed on the surviving spouse to equitably enforce the premarital

agreement. A similar result was affirmed by the Sixth Circuit in *Howard v. Branham & Baker Coal Co.*, No. 91-5913, 968 F.2d 1214 (table), (6th Cir. 1992) (text in Westlaw).

I. Trap for the Unwary

Accordingly, a properly prepared marital or premarital agreement under Texas law may ensure that the employee’s interest in the retirement plan is separate property, but such a result, in and of itself, does not negate whatever rights the spouse may have under ERISA at the time of the employee’s retirement or death absent an effective ERISA waiver of those rights.

J. Maintenance

The Family Code does not expressly address whether “maintenance” under Tex. Fam. Code § 8.001 can be waived in a premarital or marital agreement, although Sec. 4.003 does refer to the waiver of spousal support in premarital agreements. However, since “maintenance” was enacted as part of a welfare reform package, such a waiver may be against public policy.

K. Future Legislative Changes

The potential impact of future state and federal legislation (e.g., amending ERISA or adopting the concepts of quasi-community property at death, or a statutory share system, or even permanent alimony) should be considered and addressed in the agreement. Of course, these potential rights could be expressly waived in the premarital agreement, but is the waiver of a right that is not yet in existence enforceable? Generally, to be enforceable, a waiver of statutory rights must be clear, specific and unequivocal, and given by a party who has full knowledge of its consequences. In any event, the issues should be addressed and identified as specifically as possible.

L. Income Tax Basis

To the extent property is held as community property, both halves receive a new income tax basis upon the death of the first spouse under Sec. 1014(b)(6) of the Internal Revenue Code. This tax advantage is lost if community property has been partitioned into separate property.

X. FAMILY BUSINESS PLANNING

The use of modern business entities, such as corporations, partnerships and limited liability companies, has become an integral part of family estate planning. One popular technique is for family members to contribute assets to a family limited partnership in exchange for interests in the partnership. A client intending to marry can also take advantage of this planning opportunity to preserve the assets contributed to the family limited partnership for the client and the children of a prior marriage. The client’s partnership interest should remain the client’s separate property during the marriage. In other words, the assets contributed to the partnership, as well as assets acquired by the partnership, should remain partnership assets and not become marital assets of the owner and the owner’s spouse during the subsequent marriage.

Note: In any separately-owned, closely-held business enterprise where a spouse is involved in the management, Jensen v. Jensen must be factored into the planning. See II, B, supra. The short answer is to pay reasonable compensation for services rendered by the owner during marriage and maintain contemporaneous business records of the reasonableness of the compensation paid.

A. Entity Theory

The assets contributed to the partnership become the assets of the

partnership, and the partners receive partnership interests. The marital character of a spouse’s interest in a partnership created during marriage should depend on the separate or community nature of the assets contributed in exchange for the interest itself. If an interest in the partnership was acquired as a gift, the interest itself is, of course, the separate property of the donee spouse. The assets of the partnership, including undistributed income and profits, belong to the entity and do not take on a separate or community character under normal circumstances. See Sec. 152.056 of the Texas Business Organizations Code and see also *Harris v. Harris*, 765 S.W.2d 798 (Tex. App.—Houston [14th Dist.] 1989, writ denied). Caution should be taken in the day-to-day management of the partnership to avoid claims for reimbursement because of the expenditures of uncompensated time, talent or labor or contributions of community property to the separate property business. See III, B, *supra*.

B. Distributed Profits

When the partnership distributes its profits to its partners, the profits distributed to a married partner are community property, whether the partner’s partnership interest is separate or community property. This result can work a conversion of what would ordinarily be the separate property into community property. For example, if a spouse contributes separately owned oil and gas royalty interests into a partnership, the royalties collected by the partnership and then distributed to the partners as partnership profits are community property. Had the spouse not contributed the royalty interest to the partnership, the royalties received would have been the owner’s separate property. See *Marshall v. Marshall*, 735 S.W.3d 587 (Tex. App.—Dallas 1987, writ ref’d n.r.e.). The *Marshall* case has been cited for the proposition that all

partnership distributions during marriage are community property. However, some commentators argue that a distribution in excess of current or retained earnings or other distributions of capital should be separate property. See Jack Marr, *Business and Divorce*, 34th Annual Marriage Dissolution Institute (2011).

C. Comparison to Corporations

Partnerships, limited partnerships and limited liability companies are treated as entities under Texas law. The owners do not own the entity’s assets; they own interests in the entity similar to shares of stock in a corporation. A divorce court cannot award specific partnership assets to the other spouse. *Gibson v. Gibson*, 190 S.W. 3d 821 (Tex. App.—Ft. Worth 2006, no pet.). Non-liquidating distributions by the entity to the owners generally take on a community character like ordinary cash dividends distributed by a corporation to its shareholders. But, do established corporate law concepts, like the alter ego/reverse veil piercing, *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Ft. Worth 1968, writ dismiss’d w.o.j.) and reimbursement for the expenditure of community time, talent and labor like in *Jensen* apply to these new entities as well?

Reverse veil piercing has been held to be inapplicable to partnerships. See *Lifshutz v. Lifshutz*, 61 S.W. 3d 511 (Tex. App.—San Antonio, 2001, pet. denied) and *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners’ Association*, 77 S.W. 3d 487 (Tex. App.—Texarkana, 2002, pet. denied). Marr notes that the same rule may apply to limited partnerships and limited liability partnerships. See Marr, *supra*. However, he notes that the concept has been applied to limited liability companies. See *McCarthy v. Wani Venture, A.S.*, 251 S.W. 3d 573 (Tex. App.—Houston [1st Dist.] 2007, pet. denied).

The concepts of fraud on the community and reimbursement would appear to apply to any entity situation.

D. Corporate Veil Piercing

Notwithstanding the “entity” rule, the assets of a separately owned corporation have been held by Texas courts to be part of the community estate and subject to a just and right division by the divorce court in some situations. See *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Ft. Worth 1985, writ dismiss’d w.o.j.); *Spruill v. Spruill*, 624 S.W.2d 694 (Tex. App.—El Paso 1981, writ dismiss’d w.o.j.); *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Ft. Worth 1968, writ dismiss’d w.o.j.).

While the cases are not numerous and the theories used to justify the result are not always consistent, reverse veil piercing is a reality. In its landmark case, *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), the Texas Supreme Court explained the basic theories that can be used to disregard a corporate entity: alter ego, sham to perpetrate a fraud, or actual fraud. The court further explained that veil piercing is an equitable doctrine that can be used to prevent an unfair and unjust result.

In *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied), the court purported to explain the elements necessary to disregard the corporate entity. First, there must be a finding that the corporation is the alter ego of the shareholder (i.e., there is a unity between the corporation and the shareholder). Second, the shareholder’s use of the corporation damaged the community estate beyond that which could be remedied by a claim of reimbursement. While some courts have required that the shareholder must be the sole shareholder, other courts have not. See *Zisblatt*, *supra*.

The *Lifshutz* court also suggested that the use of the corporation must also

have had a negative impact on the community estate. In other words, even if the corporation is the shareholder’s alter ego, the corporation may not be disregarded unless community property was transferred to the corporation.

E. Convert Sole Proprietorships

Even if the client is not willing to share a business enterprise with other members of the family, a sole proprietorship could be converted into an entity, like a corporation, prior to the marriage. Proper management and record keeping can maintain the client’s stock in the corporation as separate property and the assets of the corporation as corporate assets, not marital assets. Continuing to operate the “business” as a sole proprietorship during the marriage is likely to result in a commingling of separate and community assets so that over time the “business” becomes community property because of the client’s inability to trace which of the business assets were owned prior to marriage or traceable to assets owned prior to marriage. Caution should be taken in the day-to-day management of the corporation to avoid claims for economic contribution and reimbursement.

F. Partnership Formation

Some divorce lawyers take the position that a general partnership interest acquired during marriage is always community property. See Marr, *supra*, citing one case decided over twenty-five years ago, *York v. York*, 678 S.W. 2d 110 (Tex. App.—El Paso 1984, writ ref’d n.r.e.). Marr’s article does state that the regular rules of characterization do apply to shares of corporate stock, limited partnership interest, interests in limited liability partnerships and interest in limited liability companies. The better view is that the separate or community character of the

partner’s interest (like shares of stock) should depend on the character of the consideration used to acquire the interest (i.e., capitalize the entity), if any. If separate consideration, the investment should be separate.

For example, if a general partnership is created at the time of the partners’ “handshake” rather than at the time the partnership agreement is signed, the individual partner’s interest in the partnership becomes property at that time and is likely to be community property under the inception rule. It was not acquired by gift, devise or descent; and if the “idea” or “concept” was an intangible that did not have a separate or community charter, the partnership interest would appear not to be traceable back to any separate property of the partner.

On the other hand, if the general partnership is not created until the partnership agreement is signed, the partner’s interest is more like a shareholder’s stock in a corporation, and it should be the partner’s separate property, if separate property was contributed by the partner to the partnership in exchange for the partner’s interest.

XI. AVOIDING PROBATE – NONPROBATE TO THE SURVIVING SPOUSE

Eventually the client’s focus in planning may shift to planning for the spouse. Further, because of the increasing popularity of non-testamentary means of disposing of property, the unlimited marital deduction, a \$5 million exemption, and the ability of the surviving spouse to take advantage of the deceased spouse’s unused exemption for estate tax purposes, couples with combined estates of \$10 million or less may be tempted to avoid the expense of more traditional estate planning in favor of

leaving the deceased spouse’s estate outright to the surviving spouse through a nonprobate means, or through a combination of a simple will and nonprobate means.

A. Inter Vivos Gift

One spouse may give to the other spouse either the donor's separate property or the donor's interest in their community property, thereby making the asset the donee spouse's separate property. *Bradley v. Love*, 60 Tex. 472 (Tex. 1883). A spouse may transfer to the other spouse the transferor spouse’s one-half community interest in community property held in either spouse’s name or in both names without going through the steps of a “partition and exchange.” *In re Marriage of Morrison*, 913 S.W.2d 689 (Tex. App.—Texarkana 1995 writ denied).

Note: Since 1980, such a spousal gift raises a presumption that the future income generated by the donated property will also be the donee spouse's separate property. Tex. Fam. Code § 3.005.

B. Partition

Spouses may partition or exchange between themselves all or any part of their community property then existing, or to be acquired, into their respective separate properties. A 2005 amendment corrected some confusion created by a 2003 amendment and now confirms that the spouses may also partition the future income generated by the property that has been partitioned. Tex. Fam. Code § 4.102.

C. Income Agreement

Since 1980, spouses may agree that income from separate property will be the separate property of the owner spouse. Tex. Fam. Code § 4.103.

D. Life Insurance

A spouse can purchase a life insurance policy on his or her own life and designate the other spouse as beneficiary. Whether the policy was community or separate, the proceeds belong to the survivor upon the insured's death. *Martin v. McAllister*, 63 S.W. 624 (Tex. 1901).

E. Employee Benefits and Other Retirement Accounts

A married employee can designate the other spouse as beneficiary of the employee's retirement plans whether the employee's interest in the plan is community or separate property. This result is even mandated by federal law for certain qualified retirement plans. I.R.C. Sec. 417(b).

F. Sec. 450 of the Texas Probate Code

Section 450 of the Texas Probate Code can apparently be utilized by spouses, as well as other individuals. This section confirms traditional nonprobate dispositions and opens the door for other creative nonprobate dispositions. Tex. Prob. Code § 450. Mutual fund accounts were added to the list in 2001.

G. C.P.W.R.O.S.

Prior to November 3, 1987, in order to create a right of survivorship of their community property for the surviving spouse, the married couple had to first partition their community property into separate property and then enter into the survivorship arrangement. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961). The 1987 amendment to Art. XVI, Sec. 15 of the Texas Constitution permitted spouses to agree in writing that all or any part of their community property shall belong to the surviving spouse without going through probate upon the death of the first spouse. Now, married couples can create

survivorship rights without first partitioning the community.

H. Amendments to the Texas Probate Code

Sec. 46 was amended in 1989 to state that Sec. 46 does not apply to any agreements between spouses regarding their community property which are now to be governed by new Part 3 of Chapter XI of the Probate Code, which was added to the Probate Code in 1989, and which has been held by the Texas Supreme Court to be the exclusive means of establishing rights of survivorship in community property. See *Holmes, infra*.

Chapter 11 purports to provide a comprehensive approach to community property with survivorship rights.

I. *Holmes v. Beatty*

The recent Texas Supreme Court case of *Holmes v. Beatty*, 290 S.W. 3d 852 (Tex. 2009) involved a nonprobate disposition of community property from the deceased spouse to the surviving spouse. In *Holmes*, the couple had acquired over ten million dollars in brokerage accounts and acquired securities certificates issued from those accounts. The investments were community property.

1. THE INVESTMENT ACCOUNTS

The investment accounts were variously listed as “JT TEN”; “Joint Tenancy”; and “Joint (WROS).” The question presented was whether these acronyms and definitions established a right of survivorship in favor of the surviving spouse. After an in-depth discussion of the *Hilley* and *McKnight* cases, the 1987 amendment to Article XVI, Sec. 15, and Texas Probate Code §§ 46(b), 451, 452 and 453, the court ruled as follows:

- a. “JT TEN” or “Joint Tenancy” – Such a designation in an account agreement signed by both spouses is sufficient to create rights of survivorship.
- b. “Joint (WROS)” – Such a designation in an account agreement signed by both spouses is sufficient to create a right of survivorship.

A critical factor in the court’s analysis of the accounts was the fact that both spouses had signed the account agreement forms provided by the financial institutions. However, the securities issued in certificate form were not signed by the couple,

2. THE CERTIFICATES

Eventually, some of the couple’s investments acquired in the “survivorship” accounts were distributed to them in certificate form with various designations, such as “JT TEN”; “JT TEN – as joint tenants with right of survivorship” and not as “tenants in common”; and “JTWROS.” The Court held that these certificates passed nonprobate to the surviving spouse at the deceased spouse’s death because the issuance of the certificates did not revoke the accounts’ survivorship agreements. Thus, the certificates carried forward the rights of survivorship created in the account agreements, even though neither spouse had signed any of the certificates.

3. AFFIRMATION

The court noted that all of the certificates included some type of “survivorship” language that reflected the couple’s expectations initially

established in the account agreements. Once the account agreements established a right of survivorship, the survivorship agreements could be revoked only by a subsequent written agreement or a disposition of the assets covered by the agreement. Texas Probate Code § 455. The issuance of the certificates to a couple with the confirming language was held not to be a disposition that revoked the survivorship agreements.

4. 2011 LEGISLATION

Part of the holding in the Holmes case has already been overruled by the Texas Legislature. Effective September 1, 2011, acronyms, such as the ones found to create survivorship rights in Holmes, will no longer be sufficient to create survivorship rights. See Tex. Prob. Code §§ 439 and 452.

J. **Choice of Laws**

In a recent opinion that had not been “released” for publication at the time this paper was written, *McKeehan v. McKeehan*, 2011 WL 2706962 (Tex. App.—Austin), the Austin Court of Appeals reversed the trial court in a probate matter where the decedent’s children had challenged the surviving spouse’s “survivorship rights” in the decedent’s investment account at work. Shortly before he died, the decedent and his spouse executed a change request form to add the spouse as a “joint owner.” The decedent’s children successfully argued before the statutory probate court that the spouse’s joint ownership interest did not have survivorship rights under Texas law.

The Court of Appeals recognized that generally personal property is governed by the law of the domicile, but held that the investment account was subject to a valid choice-of-law provision requiring Michigan law to be used to govern the account and that under Michigan law the account was

held by the decedent and his spouse as “joint tenants with right of survivorship.” Compare *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 (1947), where the Texas Supreme Court held that a Texas couple could not use New York law to partition community property into separate property before Texas law permitted such a transaction.

K. **Portability**

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 introduced the new concept of “portability.” Portability creates the possibility that the estate of a surviving spouse can take advantage of the unused estate tax applicable exemption amount from the estate of a pre-deceased spouse. For a complete discussion, see Marc Bekerman, *Portability of Estate and Gift Tax Exemptions Under TRA 2010*, Tax Management Estates, Gifts and Trusts Journal, May/June 2011.

1. “APPLICABLE EXCLUSION AMOUNT”

At least until 2013, the “applicable exclusion amount” is the sum of a decedent’s basic exclusion amount (currently \$5 million and indexed for inflation) plus, in the case of a surviving spouse, the “deceased spousal unused exclusion amount” – the basic exclusion amount of the deceased spouse, less the amount exemption actually used at the deceased spouse’s death.

2. LIMITATIONS

Currently, both spouses must die after 2010 and before 2013. The surviving spouse’s estate is limited to the unused exclusion amount of his/her most recent deceased spouse. The surviving spouse’s estate cannot take advantage of the deceased spouse’s unused exclusion

unless the deceased spouse’s estate timely filed U.S. Estate Tax Return reflecting the amount of the unused exclusion amount.

3. EFFECT ON GIFT TAX AND GST TAX

While it appears that a surviving spouse will be able to utilize the deceased spouse’s unused exclusion amount in making inter vivos gifts, there are a number of unanswered questions concerning its application, which are beyond the scope of this paper. Portability does not apply to the generation-skipping transfer tax. Any unused generation-skipping transfer tax exemption cannot be used to increase the surviving spouse’s exemption.

XII. LOST PLANNING OPPORTUNITY

Prior to “portability,” traditional estate planning frequently included couples (even with non-taxable estates) placing all or a portion of the deceased spouse’s estate (up to the deceased spouse’s exemption amount – currently \$5 million) in a “by-pass” or “credit shelter” trust, whose essential terms granted the surviving spouse an equitable life estate with a remainder interest given to the ultimate beneficiaries of the estate plan.

A. Non-Tax Advantages

The credit shelter trust offers “asset protection” from the creditors of the beneficiaries through its spendthrift provisions. It can also insulate the trust estate from claims of the beneficiaries’ spouses and successors. The trust estate avoids becoming a part of the guardianship estate of an incapacitated beneficiary.

B. Tax Advantages

The trust estate of the credit shelter trust escapes taxation at the death of the first spouse due to that spouse’s exemption equivalent, and the trust estate is excluded from the gross estate of the surviving spouse at that spouse’s later death, regardless of its value at that time. The first spouse’s generation-skipping transfer tax exemption can be allocated to the credit shelter trust so that the entire trust estate is exempt from the generation-skipping transfer tax. However, the trust estate does not receive an adjustment in basis by reason of the surviving spouse’s death because it is not included in the surviving spouse’s gross estate.

C. Terms of the Credit Shelter Trust

The terms of the credit shelter trust typically authorize the trustee to distribute income and/or principal as needed for the surviving spouse’s health, education, maintenance or support. The trust can be drafted to permit the surviving spouse to be the trustee. The surviving spouse can be given a non-general power of appointment. The remainder beneficiaries can also be permissible distributees during the surviving spouse’s lifetime.

D. Comparing Portability Planning

“Portability” planning enables the estate of a decedent to combine the unused exclusion amount of the decedent’s “last surviving spouse” with the surviving spouse’s available exemption. The maximum “portable” exemption is currently limited to \$5 million. In addition, both spouse’s must die after 2010 and prior to 2012, unless the concept is extended in subsequent legislation. The assets included in the surviving spouse’s gross estate and exempt due to the surviving spouse expanded exemption generally receive an adjustment in income tax basis equal to their

fair market value at the date of death. Only the surviving spouse generation-skipping tax exemption is available at the surviving spouse's death.

E. Larger Estates/QTIP Trusts

If the first spouse's estate exceeds the available exemption amount, traditional planning suggests that any amount in excess of the exemption should pass either outright to the surviving spouse or into a different type of spendthrift trust, a QTIP trust, for the surviving spouse. The terms of the QTIP trust must direct all of its income be paid to the surviving spouse and typically leave the trust estate to the first spouse's remainder beneficiaries upon the surviving spouse's death. The trust estate is included in the surviving spouse's gross estate and generally receives an adjustment in income tax basis.

Note: Can portability planning enable the first spouse to die to leave all or part of that spouse's estate into a QTIP trust so that the principal of the QTIP trust will be exempt from the surviving spouse's creditors through its spendthrift provisions. But some commentators have answered “no.” See Bekerman, supra.

F. Revocable Trust or Will

Whether “portability” planning or credit shelter trust planning is the strategy of choice, the planning can be accomplished through a revocable trust plan or a traditional testamentary plan. See XX, *infra*.

XIII. NON-PRO RATA DIVISION

A frequently asked question in a traditional planning situation is whether the surviving spouse and the personal representative (or the decedent's distributees) can agree to make a non-pro

rata division of the community estate so that the surviving spouse receives 100% of some of the assets and the distributees receive 100% of other community assets? The answer is an obvious “yes.”

A. Executor's Authority

The authority of an executor to enter into such a transaction should depend on the powers granted to the executor in the decedent's will. Of course, even if the will purports to enable the executor to make a non-pro rata division of the community, the surviving spouse's agreement is still required. However, the surviving spouse may have already agreed by accepting benefits under the will through either an express or equitable election. The more difficult issue is whether any such agreement will be considered a taxable exchange, subjecting the parties to capital gain exposure to the extent the assets have appreciated in value since the decedent's date of death.

Note: In a traditional testamentary plan, a safe harbor approach may be for the personal representative with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).

B. Election Planning

It is fundamental that the deceased spouse has testamentary power over only one-half of the community probate assets, whether the community assets are held in the husband's name, the wife's name, or both of their names. Absent the surviving

spouse's consent, an attempt by the deceased spouse to authorize the executor to make a non-pro rata distribution of the community is ineffective unless the attempt triggers the application of "equitable election" because the surviving spouse has accepted benefits under the will.

Note: Election planning can be used by the first spouse to dispose of both halves of the community, or of a particular community asset, as well as to encourage the surviving spouse to waive reimbursement claims, fraud on the community claims and even homestead rights. The decision to elect or not can have significant transfer and income tax consequences which are beyond the scope of this article. For a discussion of these matters and an in depth study of the Texas widow's election, see Kinnebrew and Morgan, "Community Property Division at Death," 39 Baylor Law Review 1037, 1072-1079 (1987).

C. I.R.S. POSITION

When a non-pro rata division of the community has been accomplished, three private letter rulings suggest that such an exchange is not taxable. In one, PLR 8037124, 1980 WL 134564, a husband and wife proposed to divide into two equal, but non pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; relying in part on Rev. Rule 76-85, 1976-L C.B. 215, 1976-WL 36350, the memorandum concludes that such a partition would not result in a taxable event.

In the second, PLR 8016050, 1980 WL 132102, where a husband and the executor of his wife's estate proposed an equal, but non-pro rata division, again the Service ruled the exchange was not a taxable event. In California, the ruling noted, the right of partition is to the entire community estate and not merely to some specific part,

relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. The legal entity principle relied on in the memorandum is, however, only mentioned in the context of Rev. Rul. 76-83, 1976-1 C.B. 213, 1976 W.L. 36350. Rev Rule. 76-83 ruled that a divorce non-pro rata division of community transaction was a non-taxable transaction with no gain or loss being recognized. This author has not found any definitive reference in the ruling to the community being an entity under California law. The main point of the ruling was, while a division of the community in a divorce settlement may result in a taxable event, such a division is not considered taxable when there is an equal division of the value with some assets going to the wife and other assets going to the husband. In Texas, for most purposes, community property principles do not create an entity. Community property is a form of co-ownership among a husband and wife that ceases to exist when the marriage terminates.

Note: The 1980 private letter rulings were issue prior to the enactment of 26 U.S.C.A. Sec. 1041, which provides that no gain or loss is recognized on a transfer between spouses incident to a divorce.

In the third, PLR 9422052, 1994 WL 237304 community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts.

D. The Law

Do these three rulings really support the legal conclusion that a non-pro rata

division of assets in Texas among the surviving spouse and the heirs and/or devisees of the deceased spouse is not a taxable event, or is Texas substantive law different enough to generate a different tax result? However, as discussed below, California law may not be as different as PLR 8016050 suggested.

Note: Even if the will of the deceased spouse authorized the executor to make non pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the exchange. But, consider the effect of a “widow’s election.”

E. The California Approach

Notwithstanding the comfort that the above described rulings would appear to give California couples, on Jan. 1, 1999, California amended its Probate Code. Section 100 now provides: (a) upon the death of a married person, one-half of the community property belongs to the surviving spouse and the other half belongs to the decedent, (b) notwithstanding subdivision (a), a husband and wife may agree in writing to divide their community property on the basis of a non pro rata division of the aggregate value of the community property or on the basis of a division of each individual item or asset of community property, or partly on each basis. Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non-pro rata division of community property.

Thus, it appears that, absent an agreement of the couple, California law is similar to Texas law; at death, the surviving spouse retains an undivided one-half (½) interest in each and every community asset, and the deceased spouse’s undivided one-half (½) interest passes to his or her heirs/devisees. California law differs because

of the statute that expressly authorizes the couple to agree to a non pro rata division of the aggregate value of the community property. Further, Cal. Prob Code § 104.5, which became effective on Jan. 1 2000, permits Sec. 100b agreements to be incorporated into revocable trusts.

F. Compare Texas Law

Since Texas does not have a statute expressly authorizing such an agreement, the question is whether Texas couples can enter into such an agreement. Would such an agreement be valid under existing Texas statutes and Art. XVI, Sec. 15 of the Texas Constitution? Arguably, such an agreement is valid under existing Texas law. Both Tex. Fam. Code § 4.102 and Art. XVI, § 15 of the Texas Constitution authorize spouses to partition between themselves all or part of their community property, then existing or to be acquired, as they may desire. It is not too much of a stretch to imagine this statutory language includes an agreement to divide the community property on the basis of a non-pro rata division upon the death of the first spouse.

On the other hand, a strict construction of the constitutional and statutory language suggests that only spouses, during the marriage, can partition, then existing community property, or community property to be acquired in the future. The California type agreement seems to contemplate an agreement during the marriage to partition in a certain way after the marriage terminates. Thus, such an agreement may violate Art. XVI, Sec. 15.

In *Hilley v. Hilley*, a case decided prior to 1980 amendment to Art. XVI, Sec. 15 that liberalized the spousal partition rules, the Texas Supreme Court held it was unconstitutional for a couple to enter into an agreement during marriage that would avoid a pro rata partition of the community upon the first spouse’s death. The couple in that

case tried to attach "survivorship" rights to certain community assets. *Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961). Of course, survivorship rights were later authorized by the 1987 amendment to Art. XVI, Sec. 15.

Lending support to the argument that the agreement may not violate Art. XVI, Sec. 15 is the old case of *Gorman v. Gause* 56 S.W.2855 (Tex. Comm. Of Appeals 1933) where the court, in the context of a pre-marital agreement, stated that ". . . it might be agreed by such parties that...a certain portion of the community estate, when acquired, would be conveyed by him to the wife and made her separate property. . . . Such an agreement would not violate either the Texas Constitution or statutes of this state. . . ."

Accordingly, perhaps an agreement of the spouses to partition community in a certain way following the first spouse's death would not violate existing Texas law.

G. The Revocable Trust Advantage

Until the issue raised in XIX, F, is resolved, PLR 9422052 suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan.

Note: *Even if the will of the deceased spouse authorized the executor to make non-pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the exchange. (But, consider the effect of a "widow's election.") On the other hand, in a joint revocable trust situation, the husband and wife, as the settlors of the trust, have already agreed as to the disposition of the trust estate, including perhaps a non-pro rata distribution of community assets, upon the death of the first spouse.*

XIV. COMMUNITY PROPERTY IN THE REVOCABLE TRUST

If community property is transferred into a revocable trust arrangement, the relative marital property rights of the husband and wife could be adversely affected. For example, separate and community could be commingled; community property subject to a spouse's sole management and control could become subject to the couple's joint control. Community property may be deemed partitioned.

A. Creation and Funding

Generally, when marital property is to be placed into a revocable trust (especially if the lawyer is representing both spouses), steps should be taken to insure that the planning:

1. Is not deemed fraudulent or even "illusory" under *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). (Husband placed his sole management community property into a revocable trust; upon his death, the wife disrupted the plan by pulling her one-half interest out of the trust under the "illusory" transfer doctrine);

2. Is not deemed void because one spouse unilaterally attempted to transfer community property subject to joint control into the trust under Tex. Fam. Code §3.102;

3. Does not amount to a partition of community property under Section 4.102 of the Texas Family Code unless that is desired by the parties;

4. Does not work a commingling of community and separate funds as to risk losing the separate character of the separate property, unless that is desired by the parties;

5. Does not convert one spouse's retained equitable interest in his or her sole management community property into joint community property and thereby expose it to liability for the contractual debts of the other spouse; and

6. Defines which assets the trustee should use to provide for, and pay the debts of, the spouses while both are alive, and to satisfy claims of creditors upon the first spouse's death.

Note: Texas community property law may create a unique planning opportunity when one spouse is incapacitated. Following a judicial declaration of incapacity, the other spouse, in the capacity of the community administrator, is granted the sole power of management, control and disposition of the entire community estate. Does this authority give the managing spouse the power to create and fund a revocable trust? Absent the judicial declaration, the competent spouse still retains sole authority over his/her special community property. In Land v. Marshall, the Texas Supreme Court held that the husband's creation of a revocable trust with his sole management community without his wife's joinder was not void as to the wife's one-half interest, but voidable at her election under the “illusory transfer” doctrine.

B. Distributions

Careful consideration should be given to the trustee's duty to support the couple while both are still surviving. Generally, the terms of the trust should specify whether trust income is to be distributed or retained and if distributed, whether distributions to the husband, wife, or both, are appropriate. It may be advisable to distribute what would otherwise be a spouse's special community income (income

from separate property or existing special community property) to that particular spouse. If such income is retained, it may be advisable to hold and invest it, in trust, as “special community.” When the trustee is authorized to distribute income or principal for the spouses pursuant to an ascertainable standard, the terms of the trust need to specify what sources are to be exhausted first (i.e., use separate before community, or use community before separate and which type of community is expended first—special or joint). The terms should also specify whether the trustee is to consider other means of support prior to making a distribution. A different set of distribution criteria may be appropriate during those periods the spouses are incapacitated.

C. Power of Revocation

When a husband and wife fund a revocable trust with community property, should the power of revocation be exercised jointly or severally? If the document directs that either spouse can revoke the trust unilaterally, should the power extend to the whole community asset being withdrawn from the trust or only to the revoking spouse's undivided one-half interest therein?

1. JOINT REVOCATION

If the power to revoke is retained jointly by the couple, the couple's equitable interest in the trust would appear to be their joint community property even though some of the community assets in the trust were a spouse's special community property prior to funding. Converting special community property into joint community property affects the relative marital property rights of the husband and wife. For example, an asset which would have been exempt from certain debts of a particular spouse would become liable. See *Brooks v. Sherry*

Lane National Bank. 788 S.W. 2d 874 (Tex. App.—Dallas 1990). See IV. A., *supra*.

2. UNILATERAL REVOCATION

To avoid converting special community property into joint community property, the document could be drafted to permit either spouse to withdraw from the trust that spouse's community one-half interest in any community asset placed in the trust. This approach has several problems. Such a power would, in effect, permit either spouse to unilaterally partition the couple's community property interests, a result which does not appear to be authorized by Art. XVI, Sec. 15 of the Texas Constitution. Only jointly can spouses partition community property into their respective separate estates. Even an agreement by the spouses to authorize such a unilateral partition would appear to violate the "mere agreement" rule of marital property. See *Kellet v. Trice* 95 Tex. 160, 66 S.W. 51 (1902); *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 (1947); *Hilley v. Hilley*. 161 Tex. 569, 342 S.W.2d 565 (1961).

Note: If unilateral revocation is desired, the more considered solution may be to allow one spouse, with notice to the other, to withdraw their special community and any joint community property with the joint community property being distributed in both names.

3. "JOINT AND SEVERAL" REVOCATION

Accordingly, the safe harbor approach may be for the couple to retain power of revocation (i) jointly for some assets of the trust, (the joint community property assets) and (ii) unilaterally as to other assets in the trust (special

community property and separate property) after giving notice to the other spouse. If the several power of revocation is exercised as to a special community asset, the withdrawn asset would remain the couple's community property, but still subject to the withdrawing spouse's sole management and control. If the couple so agrees, allowing either spouse to revoke as to a joint community asset would not appear to have any adverse consequences from a constitutional, liability or tax perspective so long as the asset in its entirety is revested as community property.

D. **Subsequent Incapacity of a Settlor**

As with any revocable trust, the trust document should address the effect the possible incapacity of a settlor will have on the power of revocation. Can an agent under a durable power of attorney revoke on behalf of the settlor/principal? Can a guardian revoke the ward's revocable trust? Is the power of revocation a non-delegable power? See *Weatherly v. Byrd*, 566 S.W.2d 292 (Tex. 1972). The questions evolve even further if the settlor is married and the trust is funded with the incapacitated spouse's special community property or joint community property. Do Sec. 883 of the Texas Probate Code and Sec. 3.301 of the Texas Family Code permit the other spouse to revoke the trust on behalf of the incapacitated spouse? Texas law provides no clear answers to these questions, thus, the document should address all of them.

E. **Effect of Divorce**

Community assets and quasi-community property held in trust where one, or both, of the spouses hold a power of revocation should be part of the "estate of the parties" subject to division by the divorce court in a just and right manner

pursuant to Sec. 7.001 of the Texas Family Code.

1. POWERS OF APPOINTMENT

A power of revocation is defined in the Texas Property Code as a general power of appointment, giving the holder thereof the equivalents of ownership over the assets subject to the power. See Tex. Prop. Code § 181.001.

2. VOID AND VOIDABLE TRANSFERS

If only one spouse is the settlor of a trust funded with the settlor spouse's special community property, the transfer of such community assets into the trust is deemed "illusory" as to the other spouse. See *Land v. Marshall*, IX, B, *supra*. If the sole settlor spouse attempted to transfer into the trust joint community assets without the joinder of the other spouse, the transfer should be found to be void as to the other spouse.

3. SEPARATE TRUST ESTATE

If the settlor spouse transfers separate property into a revocable trust arrangement, (a) the original trust estate and its traceable mutations should retain the separate character of the separate property contributed to the trust, (b) trust income distributed to the settlor is community property and (c) any undistributed income and its mutations should be deemed to be community due to the settlor's power of revocation.

4. TRANSFERS TO THIRD PARTIES

Any trust income or any other community assets held in the trust and distributed by the trustee to a third party, such as a child of the settlor from the settlor's prior marriage, is usually deemed to be a completed gift by the settlor to the third party for tax purposes

(unless the distribution satisfied the settlor's legal obligations of support) and is subject to attack by the other spouse as being a transfer in fraud of the other spouse's community property rights.

5. REVOCABLE TRUSTS BECOMING IRREVOCABLE

If, during the marriage, a revocable trust becomes irrevocable due to a modification by the settlor, or due to the trust terms (e.g., the trust provides that it becomes irrevocable upon the settlor's incapacity or death), (a) the interests of the non-settlor beneficiaries may become fixed, vested and/or ascertainable, (b) the settlor may be deemed to have made a completed gift for tax purposes and (c) the now completed transfers to the non-settlor beneficiaries are subject to scrutiny as being transfers in fraud of the other spouse's community property rights.

6. INCOME TAXES

The income generated by revocable trust assets is taxable to the settlor whether or not the income is distributed to the settlor, retained in the trust or distributed to another beneficiary of the trust. Because the income either retained in the trust or distributed to a third party is still reported on the settlor's individual income tax return (typically a joint return with the settlor's spouse), the payment of the consequential income tax liability with community funds could adversely affect the rights of the other spouse.

7. PLANNING FOR DIVORCE

While Section 472 voids provisions in favor of the former spouse and the former spouse's relatives, in the event of a subsequent divorce, other problems exist if the trust is a joint revocable trust

that provides for "joint revocation" and does not address what happens to the power of revocation in the event of a divorce. Further, it is not difficult to imagine the problems trying to interpret and construe the remaining terms of the trust. In that situation, it would likely serve both settlors to address these issues in the divorce settlement.

Awkward as it might be, it would be even better to address the possibility of a subsequent divorce in the trust agreement and how it would impact the power of revocation and the other terms of the trust.

F. Death of First Spouse

Upon the death of the first spouse to die, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust (perhaps by-pass and QTIP trusts) or are distributed in accordance with the provisions of the trust document. For further discussion, See X, *infra*, Non-Pro Rata Distributions.

G. Survivor's Interests

Upon the death of the first spouse, the surviving spouse's separate property and one-half interest in the community property generally should be delivered to the surviving spouse or segregated into a "survivor's trust" that continues to be revocable by the surviving spouse unless a different result is desired after considering the consequences of it becoming irrevocable. In addition to the substantive advantages for the surviving spouse, continuing revocability prevents an unintended taxable gift on the part of the surviving spouse. If the surviving spouse is not a settlor of the trust (or did not otherwise agree to the terms of the trust) and does not receive the survivor's one-half interest in the community property, the settlor spouse can

use the "illusory trust" argument to reclaim the survivor's one-half interests in the community trust assets. See *Land v. Marshall* at XIV, A, *supra*.

H. Amending the Survivor's Trust

Quite often these joint trusts do allow the surviving spouse to amend the "survivor's trust" after the death of the first spouse, but are silent about any unilateral amendment while both are living.

Generally no problems are encountered if both of the spouses agree to an amendment. But, what if one spouse wants to amend but other does not (or cannot). This may not be permitted unless stated in the trust.

However, if the amendment only impacts the disposition of the surviving spouse's property after the first spouse's death, but the trust is silent on the point, can a spouse make those changes while both are alive? Even then, is notice necessary?

Obviously, this is an issue that should be addressed in the trust agreement. If the trust permits unilateral changes, it should include not only the dispositive provisions but any and all administrative provisions as applied to that survivor's dispositive provisions including but not limited to who could serve as trustee of any trusts that spring up after the death of one or both of the settlors.

I. Planning Considerations

When drafting the trust document, separate trusts may be desirable for the husband's separate property, the wife's separate property and their community property. In fact, it may be advisable to segregate the community property further into three separate sub-trusts, one for the husband's sole management community property, one for the wife's sole management community property, and one for their joint community property in order

to maintain their relative marital property rights, to facilitate the management rules of Sections 3.101 and 3.102 of the Texas Family Code and to continue the liability exemption rules of Section 3.202 of the Family Code, otherwise the couple's relative rights are affected and the attorney is placed in a conflict of interest by trying to represent both spouses in the planning. Finally, the trustee should be instructed to pay debts and other expenses in a manner consistent with the liability rules of the Texas Family Code.

J. Community Property Basis

Because the decedent's interest in the revocable trust assets is included in the gross estate, such assets will receive a new income tax basis. However, if a married couple is creating the revocable trust and plan on placing community property in the trust, care should be taken in the drafting of the trust agreement and the other transfer documents to make sure that the funding of the trust with community property does not amount to a partition of the community property that would jeopardize the new income tax basis both halves of the community can receive upon the death of the first spouse. See Rev. Rul. 66-283, 1966-2 C.B. 297.

XV. THE HOMESTEAD IN TRUST

The transfer of assets to the revocable trust may result in the loss of certain probate provisions which protect the surviving members of the family from the decedent's creditors (i.e., the probate homestead, exempt personal property, family allowance and the claims procedures followed in probate administration) following a decedent's death.

A. Probate Homestead

The Texas Constitution provides that, on the death of a homestead owner, the

homestead is to descend and vest in like manner as other real property of the deceased but that it shall not be partitioned among the heirs of the deceased during the lifetime of the surviving spouse for so long as the survivor elects to use or occupy the same as a homestead, or so long as the guardian of the minor children of the deceased may be permitted, under the order of the proper court having the jurisdiction, to use and occupy the same. Tex. Const. Art. XVI. § 52 (1987). The effect of this constitutional mandate is to vest a “life estate” in the surviving spouse until abandonment, or a right to receive an estate until majority for minor children. *Thompson v. Thompson*, 236 S.W.2d 779 (Tex. 1951). In addition, the Texas Probate Code provides that following the owner's death, the homestead will not be liable for any debts, except for the purchase money thereof, the taxes due thereon, or work and material used in constructing improvements thereon. Tex. Prob. Code § 270. Further, the Texas Probate Code directs the probate court to set apart for the use and benefit of the surviving spouse and minor children all such property of the estate as is exempt from execution or forced sale by the constitution and laws of the state. Tex. Prob. Code § 271.

Note: Prior to 2005, Texas case law appeared to grant the exemption from creditors if the owner was survived only by an unmarried child living at home. 2005 amendments to Sections 271 and 272 may have inadvertently eliminated that exemption.

B. Right of Occupancy

Will the surviving spouse have a right to occupy the home following the death of the owner if it was placed in a revocable trust prior to its owner's death? While there are no definitive cases on point,

it appears that the surviving spouse may not have such a right unless the trust document so provides. First, whether the home was community property or not, if the home was placed in the revocable trust during marriage, both spouses would have had to join in the transaction or the conveyance would have been void. Tex. Fam. Code § 5.81. See also Tex. Prop. Code § 41.0021(c). Second, the Texas Supreme Court has approved provisions in premarital agreements that allow one to waive his/her homestead right of occupancy. However, it has also been held that such waivers must be clear and unambiguous and with full disclosure. See *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978) and *Hunter v. Clark*, 687 S.W.2d 811 (Tex.App.—San Antonio 1985).

But what if the home had been placed into the revocable trust by its owner before the marriage, or if the owner places it in trust during the marriage but before it is used as the home? In either situation, the survivor's right of occupancy may never come into existence because the right may only attach to the actual property interest owned by the owner, which in the revocable trust situation is an equitable life estate that terminates upon the settlor's death. This same rationale may even defeat the possession rights of the owner's minor children.

On the other hand, perhaps public policy in favor of the surviving spouse and minor children will lead the courts to extend the "illusory transfer" concept to such a situation to protect the rights of the surviving spouse and minor children to occupy the home like it did to protect the surviving spouse's community one-half interest unilaterally placed in a revocable trust in *Land v. Marshall*, discussed at IX, B, *infra*.

Note: *It should be noted that Section 41.0021(c) was an amendment to the exemption from creditors' section of the Texas Property Code and not intended to address "the right of occupancy" under the Texas Constitution. See Tex. Const. Art XVI, § 52 (1987).*

This possible loss of the right of occupancy is consistent with the constitutional and statutory homestead provisions because both contemplate the homestead being a probate asset upon the death of the owner. If the home has been placed into a revocable trust, the settlor's life estate terminates and the remainder beneficiary's interest becomes possessory upon the death of the settlor instead of going through probate.

C. Creditor's Rights

Assuming the settlor is survived by a "constituent family member" (surviving spouse, minor child and possibly the unmarried adult child still at home), will the home placed in a revocable trust continue to be exempt from most creditors of the settlor upon the settlor's death? Again, there are no definitive cases and the likely result is not very clear. First, a creditor could argue that, if the constituent family members have lost their right of occupancy, the purpose in exempting the property is frustrated and, therefore, the creditors should be able to reach the asset like any other revocable trust asset. Second, the creditors will point out that the exemption from creditors is found in the probate code and is directed at probate assets; thus, where the owner elected to take the home out of probate, its exemption is lost. On the other hand, the basic theory that supports the creditor's position, in effect, ignores the existence of the trust, thereby revesting the settlor with the property and returning it to his/her probate estate where it would have been exempt from the claims of the creditors in the first place. In other

words, the creditors have essentially forced the settlor to revoke the trust thereby making the home probate property again and, therefore, entitled to probate protection. The 2009 amendment to the Texas Property Code § 41.0021(c) does not address this specific issue.

D. Exempt Personal Property

Normally, certain items of tangible personal property are exempt from most of the decedent's creditors if the decedent is survived by a constituent family member. Tex. Prob. Code §§ 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed \$60,000. Tex. Prop. Code § 42.002. In addition, during administration, the family members can retain possession of these items and will receive ownership of them if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his/her heirs and/or devisees when the administration terminates. Tex. Prob. Code § 278. The arguments "pro" and "con" as to whether these rights exist if these otherwise exempt items are placed in a revocable trust would seem to parallel the above homestead discussion.

E. Family Allowance

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code §§ 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex.Civ.App.—Corpus Christi 1967, no writ). Thus, it appears that the family allowance would be lost if all of the decedent's assets have been placed in a revocable trust.

Note: 2011 legislation expanded the definition of the individuals having exempt property and family allowance rights to the decedent's adult children who are incapacitated. See Tex. Prob. Code §§ 271, 272 and 286.

XVI. PLANNING FOR DESCENDANTS

In either a traditional testamentary or revocable trust plan, the client should consider possible marital property planning for the client's descendants. For example, whether or not the client trusts the son-in-law, steps can be taken to hopefully enable the daughter to maintain the separate character of any inter vivos or testamentary gifts.

1. SEGREGATED ACCOUNTS

At a minimum, the daughter should be advised to "keep her separate, separate" by opening bank and brokerage accounts in her individual name (perhaps with a designation "separate account") and only depositing into the account her separate property. Contemporaneous business records showing the source of any and all separate deposits should be retained in the event proof of separate character of the account is later needed.

2. AVOID INADVERTENT COMMINGLING

In a state like Texas, where income from separate property is community property, any interest (or other income generated by the account) should be paid into a different account in her name (perhaps with a designation of "special community account") in order to avoid a "commingling" of community and separate funds in the separate account. If

an account is "commingled," it becomes community property.

3. SEPARATE INVESTMENTS

Any investment given to her, purchased with funds in her "separate account" or certificates issued out of her separate account, should be held in her name only. Further, real estate conveyed to her should be conveyed to her "as her separate property." Again, contemporaneous business records can serve as evidence of the nature of the transaction and the separate character of the asset and should be retained.

4. FAMILY ENTITIES

If the daughter is to be a partner in a family partnership, a member in a family-oriented limited liability company or a shareholder in a closely-held corporation, her interest should be given to her as a gift (or purchased with traceable separate property). Again contemporaneous business records of the nature of the transaction should be retained. If she expends any "time, talent or labor" in the management of the entity, paying her a reasonable compensation for those personal services should be considered to hopefully avoid a later reimbursement claim by her husband.

5. ASSET PROTECTION TRUSTS

Any and all of the inter vivos or testamentary gifts could be placed in an asset protection trust for the daughter's benefit during her lifetime. The spendthrift provisions will help not only insulate the daughter's interest from the claims of her creditors, but also any community property claims of the son-in-law. Including a statement in the trust agreement that it is the settlor's intent that any and all interests of the daughter,

as well as any and all distributions to her out of the trust, are her separate property may not be conclusive, but may prove to be persuasive in future litigation.

Limiting distributions of income and/or principal to an ascertainable standard (health, education, maintenance, or support) is especially important if the daughter is going to be the trustee or is going to be given general power of appointment. If a third party is going to serve as trustee, income distributions to her could be at the discretion of the trustee or pursuant to an ascertainable standard. Caution should be exercised in granting any other powers to the daughter over the trustee or the trust estate. Carefully planning and drafting the terms of the trust could prove to be persuasive in maintaining the trust as her separate property.

6. DAUGHTER'S COUNSEL

Counsel can be retained to advise the daughter on what other planning tools are available to her in order to insulate "her estate" from any possible community property claims of her husband (or his successors or creditors) and/or to review the daughter's planning to ensure that what can be done has been done to insulate the daughter's inheritance from any possible claims of the son-in-law (or his successors or creditors).

Finally, the fees of the daughter's counsel should be paid by the daughter with her separate property or by the client to avoid any claim by the son-in-law that the daughter misused their community property to his detriment.

XVII. MEDICAID PLANNING?

The focus of this paper is on what has been referred to as “traditional” estate planning within the context of Texas marital property law (i.e., transfer tax, creditor and divorce/probate protection of the client’s “estate”). Absent from this paper is what is commonly referred to as “elder law” planning, where the objective typically is to either (i) qualify (or maintain eligibility) for governmental “needs-based” benefits, like Medicaid, or (ii) insulate assets from recovery programs, like MERP.

This type of planning is outside the scope of this paper. If elder law planning is being considered, the author recommends Clyde Farrell and Bliss Pak, “*Protecting Homes, Farms and Ranches and Other Businesses Under the Medicaid Rules*,” 13th Annual Estate Planning, Guardianship and Elder Law Conference (UTCLE 2011), for an excellent overview.