HOT MARITAL PROPERTY TOPICS

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I. INTRODUCTION

Increasingly, married couples own interests in, and receive distributions from, business organizations and trusts, some of which were created by the spouses, or a spouse, and others were created by third parties, typically their parents or deceased prior spouses. Another reality is that married couples move from and to Texas. The marital property character of a couple's property under these circumstances is particularly important when the marriage terminates, either in divorce or upon the death of one of the spouses. Accordingly, marital property characterization upon termination of the marriage, absent a pre-marital or marital agreement, is the primary focus of this paper. The paper begins with a review of the relevant foundational principles of Texas marital property law (Chapter II, characterization, and Chapter III, management).

II. MARITAL PROPERTY CHARACTERIZATION

The Supreme Court of Texas in *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925) and *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902) made it clear to practitioners and the legislature that it is the Texas Constitution which ultimately defines what is separate or community property and not the legislature or the parties involved. Accordingly, in order to properly characterize marital assets in Texas, it is necessary to understand the relevant provision of the Texas Constitution, Article XVI, Sec. 15 (eff. Jan 1, 2000).

A. Article XVI, Sec. 15

All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud preexisting creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses may also from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; and if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property.

B. The Test for Community

It is important to note that the Constitution does not define community property. *Arnold v. Leonard*, *supra*, explained the significance of the Texas constitutional approach to characterization: if an asset does not fall within the constitutional definition of separate property (property owned prior to marriage or that is acquired during marriage by gift, devise or descent), it must be community property — "the rule of implied exclusion." A logical extension of this rule leads to a more practical definition for the term "community property": *that property of the marriage which is not proven to be separate property. See* II, C, *infra*.

1. *Graham v. Franco*

The court in *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), resorted to a more historical Spanish/Mexican approach and affirmatively defined community property as ". . . that property is community which is acquired by the works, efforts, or labor of the spouses. . . ." *See also Whittlesey v. Miller*, 572 S.W.2d 665 (Tex. 1978); *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977).

2. Income from Separate

The rationale of *Graham v. Franco*, *supra*, would suggest that any income generated by a spouse's separate property would be the owner's separate property. However, the general rule concerning income from separate property is that it is community property, placing Texas in a minority position among the community property states. *See Arnold v. Leonard, supra*.

3. Traceable Mutations

Arnold v. Leonard's "rule of implied exclusion" would suggest that property purchased with separate property during a marriage would be community property. However, Texas courts, going all the way back to *Love v. Robertson*, 7 Tex. 6 (1855) and *Rose v. Houston*, 11 Tex. 323 (1854), have consistently held that such property is a "traceable mutation" of the consideration used to acquire the property. Thus, the character of separate property is not changed by a sale, exchange or change in form. *Texas Pattern Jury Charges*, PJC 202.4 (2018).

Note: *Absent an agreement of the parties and notwithstanding some of these cases, the author is of the opinion that "the rule of implied exclusion" remains the general rule for determining what is community property or separate property.*

C. 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 § 3.003.

1. Management Presumption

The fact that an asset is held in one spouse's name only, or is in the sole possession of a particular spouse, is not determinative of its marital character and only raises a presumption that the asset is subject to that spouse's sole management and control while the community presumption dictates it is presumptively community. Tex. Fam. Code § 3.104.

2. Form of Title

The fact that record title is held in a particular way due to certain circumstances may cause the community presumption to vanish in favor of a rebuttable separate presumption. *See Smith v. Strahan*, 16 Tex.

314 (1856); *Higgins v. Johnson*'s *Heirs*, 20 Tex. 389 (1857); *Story v. Marshall*, 24 Tex. 305 (1859). The other spouse may not be allowed to rebut the presumption if that spouse was a party to the transaction. *Lindsay v. Clayman*, 151 Tex. 593, 254 S.W.2d 777 (1952).

D. Traditional Means of Creating Separate Property

Consequently, the first step of characterization is ascertaining the facts and circumstances surrounding the acquisition of an asset – "the inception of title rule." *Creamer v. Briscoe*, 109 S.W. 911 (Tex. 1908). The second step is determining whether evidence of those facts and circumstances place the asset within the definition of separate property. Prior to the 1980 Amendment to Art. XVI, Sec.15, there were limited means of creating separate property in Texas. Generally, separate property was limited to:

1. <u>Previously Existing</u>

Property owned prior to marriage. Tex. Fam. Code § 3.001.

2. <u>Gratuitous Transfers</u>

Property acquired during marriage by gift, devise or descent. Tex. Fam. Code § 3.001.

3. <u>Marital Partitions</u>

Property resulting from the partition of presently existing community property. Tex. Fam. Code § 4.102.

4. <u>Certain Credit Acquisitions</u>

Property acquired on credit during marriage is separate property if the creditor agreed to look only to separate property for repayment. *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956).

5. <u>Personal Injury Recoveries</u>

Certain personal injury recoveries. Tex. Fam. Code § 3.001.

6. <u>Traceable Mutations</u>

Property acquired during marriage which is traceable as a mutation of previously owned separate property. *Tarver v. Tarver*, 394 S.W.2d 780 (Tex. 1965). Even casualty insurance proceeds traceable to separate property are separate property even if the premiums were paid with community. Tex. Fam. Code § 3.008.

E. 1980 Amendment

The 1980 amendment to Art. XVI, Sec. 15 authorized the creation of separate property in new ways:

1. <u>Premarital Partitions</u>

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

2. <u>Spousal Partitions</u>

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

3. <u>Income from Separate Property</u>

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

4. <u>Spousal Donations</u>

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

F. Mixed Characterization

Property acquired during marriage may be part separate property of one or both spouses and part community property. Such an item may be part separate property of each spouse. Certain assets, like bank accounts, may be brought into a marriage, but take on mixed characterization during marriage.

1. Inception of Title

If the community estate of the spouses and the separate estate of a spouse have an ownership interest, the respective ownership interests are determined by the inception of title rule. Tex. Fam. Code § 7.006. For example, when the consideration used to acquire an item of property consists of both community property and traceable separate property, the item is both separate and community property.

2. Calculation

The part that is separate property is the percentage of the purchase price paid with separate property or "separate credit" (i.e., the creditor agreed to look to separate property for payment. *See* II, D, 4, *supra*.) To calculate a separate property interest, one can divide the separate property contribution by the total purchase price. The percentage interest remaining after all separate property interests have been deducted is community property. *Texas Pattern Jury Charges*, PJC 202.6 (2018).

3. Part Gift, Part Purchase

Property may be acquired partly by *gift* and partly by purchase. In such a case, the portion acquired by *gift* is separate property. The portion acquired by purchase can be separate, community or both, depending on the source of the funds or credit used to make the purchase. *Texas Pattern Jury Charges*, PJC 202.6 (2018).

G. Commingling

An item of property that might have "mixed characterization" is presumptively community, meaning the party asserting the separate character of an interest in the item must prove the separate interest is separate property by clear and convincing evidence. The failure to meet that burden of proof results in commingling and the property being community property.

Certain types of assets are particularly susceptible to this result. They are bank accounts, brokerage accounts, IRA accounts and even ERISA defined contribution retirement plans. Texas Family Code Section 3.007 provides that the separate property interest in a defined contribution retirement plan may be traced using the same tracing and characterization rules that apply to other assets.

Note: *In these types of assets, the failure to meet the burden of proof results in a "commingling" and the accounts and/or plans being community property.*

H. Quasi-Marital Property

According to the Texas Family Code, the separate property of a spouse which was acquired while the spouses were not residing in Texas, but what would have been community had they resided in Texas at the time of acquisition, will be treated in a divorce proceeding as if it were community property. Tex. Fam. Code § 7.002. *See Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). 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. Quasi-community property is still treated as separate if the marriage terminates by reason of a spouse's death.

Hanau v. Hanau, 730 S.W.2d 663 (Tex. 1987). 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.

I. Observations

Today, in order to properly characterize a spouse's interest in a business organization or a trust, one needs to be thoroughly familiar with the ever changing rules of characterization and be alert to the possibility that in either a premarital or marital agreement the parties changed the legal result. For example, income from separate property is not always community property. *See* II, E, *supra*.

III. MARITAL PROPERTY MANAGEMENT

Unlike characterization, rules relating to the management of marital property are within the rulemaking authority of the legislature. *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925). The Texas Family Code now prescribes which spouse has management powers over the marital assets during the marriage.

A. Texas Family Code

1. <u>Separate Property</u>

Each spouse has sole management, control and disposition of his or her separate property. Tex. Fam. Code § 3.101.

2. <u>Sole Management Community</u>

Each spouse has sole management, control and disposition of the community property that he or she would own, if single, including personal earnings, revenue from separate property, recoveries for personal injuries and increases and revenues from his or her "special community property." Tex. Fam. Code § 3.102(a).

3. <u>Joint Management Community</u>

All other community property is subject to both spouses' joint management, control and disposition – "the joint community property." Tex. Fam. Code § 3.102(b).

B. Presumptions

In addition to the community presumption of Section 3.003, an asset titled in one spouse's name (or untitled but in the sole possession of one spouse) is presumed to be subject to that spouse's sole management and control. Tex. Fam. Code § 3.104. Thus, an asset held in either spouse's name is presumed to be that spouse's sole management community property. However, the actual definition of "sole management community property" is found in Tex. Fam. Code § 3.102(a). If an asset does not fall within the statutory definition of "sole, management community," it is "joint community," even if held in one spouse's name.

C. Record Title

Whether an asset is held in one spouse's name or in both spouses' names, it is presumptively community property, thereby placing the burden on a spouse claiming separate status to prove why it is separate property.

1. <u>Presumption</u>

The fact that title is held in one spouse's name (or it's untitled, but in the sole possession of one spouse) creates a rebuttable presumption that the asset is the spouse's sole management community property. Tex. Fam. Code §

2. Rebutting the Presumption

If the facts indicate that a community asset is not property the "titled" spouse would have owned, if single (e.g., personal earnings, income from separate property, increases and expenses from special community property), Section 3.102(c) indicates it is joint community.

3. Mixing Sole Management Community

If one spouse's sole management community is "mixed" with the other spouse's sole management community (or presumably their joint community), the "mixed" community is converted into joint community and subject to both spouses' debts. This result typically occurs when the spouses deposit their respective salaries into a joint account. If an asset is subsequently purchased with funds from the joint account and placed in one spouse's name (absent donative intent of the other spouse), the asset is presumptively subject to that spouse's sole management, but may be found to be joint community for liability purposes due to its traceable "joint" source.

4. The "Sole Management" Joint Account

If only one spouse deposits his or her special community funds into a joint account, the account is community property, and the account agreement will dictate who can write the checks or otherwise make withdrawals (typically, either spouse can write a check or make a withdrawal). However, if the other spouse's creditors attempt to subject it to the contractual debts of the non-depositing spouse, the depositing spouse has a good argument that the account is still the depositing spouse's special community property and exempt from other spouse's non-tort and any premarital creditors. A joint account belongs to the party who deposited the funds. Tex. Est. Code § 113.102.

D. Observations

Even if a distribution from the business organization or a trust is separate property, its deposit into a financial account may result in a commingling with community deposits so that the account (and the separate deposits) becomes community property. A sole management community distribution may become "mixed" community property if deposited into an account that includes deposits of the other spouse's sole management community or the couple's joint management community. "Mixed" community becomes joint management community property. Similarly, the proceeds from the sale of a separate interest in a business organization or a trust distribution may become commingled community property if mixed with community funds.

IV. MARITAL PROPERTY LIABILITY

The Legislature's basic rules of marital property liability are found in Sections 3.201, 3.202 and 3.203 of the Texas Family Code.

A. Statutory Rules

1. Separate Property Exemption

As a general rule, a spouse's separate property is not subject to the debts of the other spouse. Tex. Fam. Code § 3.202(a).

2. Special Community Exemption

As a general rule, a spouse's sole management community property is not subject to any debts incurred by the other spouse prior to the marriage or any nontortious debts of the other spouse incurred during the marriage. Tex. Fam. Code § 3.202(b).

3. Other Rules of Law

These two exemptions exist unless both spouses are personally liable under "other rules of law." Tex. Fam. Code § 3.201. *See* IV, B, *infra*.

4. Exempt Property

Of course, the family homestead and certain items of personal property are generally exempt from the debts of both spouses, regardless of the marital character of the property. Tex. Prop. Code §§ 41.001 and 42.001. The Texas Property Code and Texas Insurance Code also create exemptions for retirement benefits and life insurance.

5. Creditors' Rights

Accordingly, a spouse's nonexempt separate property and sole management community property are subject to any liabilities of that spouse incurred before or during the marriage. Nonexempt joint community is liable for the debts of both spouses. In addition, the nonexempt sole management community properties of both spouses are subject to the tortious liabilities of either spouse incurred during marriage. Tex. Fam. Code § 3.202 (c) and (d).

6. Order of Execution

A court may determine, as deemed just and equitable, the order in which particular separate or community property is subject to execution and sale to satisfy a judgment. In determining the order, the court is to consider the facts and circumstances surrounding the transaction or occurrence on which the debt is based. Tex. Fam. Code § 3.203.

B. Other Factors

The general rules described in III, A, *supra*, apply unless both spouses are personally liable under "other rules of law."

1. Joint Obligations

Of course, both spouses may sign a contract or commit a tort which would make them jointly and severally liable and thereby subjecting the entire nonexempt marital estate to liability. "Generally, both spouses are jointly and severally liable for the tax due on a joint return. Thus, a spouse may be liable for the entire tax liability, although the income was totally earned by the other spouse." *Kimsey v. Kimsey*, 915 S.W.2d 690, 695 (Tex. App.—El Paso 1998, pet denied).

2. "Necessaries"

Each spouse has a duty to support the other spouse and a duty to support a child generally for so long as the child is a minor and thereafter until the child graduates from high school. Tex. Fam. Code Secs. 2.501 and 154.001. Accordingly, all nonexempt marital assets (separate and community) are liable for such "necessaries." *See*, IV, D, *infra.*

3. Principal-Agent

The law also defines other situations where any person can be held personally liable for debts of another. These situations include the following relationships: respondeat superior, principal/agency, partnership, joint venture, etc. These special relationships can exist between husband and wife and can impose vicarious liability on an otherwise innocent spouse. *See Lawrence v. Hardy*, 583 S.W.2d 795 (Tex. App.—San Antonio 1979, writ ref'd n.r.e.). The Texas Family Code has codified this concept. Tex. Fam. Code § 3.201(a)(1). However, the marriage relationship, in and to itself, is not sufficient to generate vicarious liability. Tex. Fam. Code § 3.201(c). *See also Wilkinson v. Stevision*, 514 S.W.2d 895 (Tex. 1974).

4. Points of Clarification

Except as provided in IV, B, *supra*, community property is not subject to a liability that arises from act of a spouse. Tex. Fam. Code §3.201(b). Retirement allowances, annuities, accumulated contributions, optional benefits and money in the various public retirement system accounts *which are one spouse's sole management community property* are generally not subject to a claim of a criminal restitution judgment against the other spouse. Tex. Fam. Code § 3.202(e).

C. Child Support

Prior to 2007 legislation, unless otherwise agreed in writing or ordered by a court, a parent's child support obligation ended when the parent died; now the Family Code provides that court-ordered child support obligations survive the obligor's death. Tex. Fam. Code § 154.006. Subsequent amendments to the Family Code also provide that the obligor's child support obligations can be accelerated upon the obligor's death and a liquidated amount will be determined using discount analysis and other means. Tex. Fam. Code § 154.015. An amendment to the probate code makes the liquidated amount a class 4 claim. Tex. Est. Code § 355.102. The court can also require that the child support obligation be secured by the purchase of a life insurance policy. Tex. Fam. Code § 154.016.

D. The Necessaries Doctrine

A spouse's duty of support extends beyond the marital relationship itself. A spouse who fails to discharge this duty is liable to others who provide necessaries to the other spouse. Tex. Fam. Code § 2.501(b). Accordingly, when third parties (e.g., doctors, hospitals, nursing homes – perhaps even lawyers) provide services deemed reasonably necessary for one spouse's support, both spouses are personally liable for the costs of such services. While the spouse who actually incurs the debt may be deemed to be "primarily liable," both spouses are "jointly and severally" liable to the third party under the necessaries doctrine. Tex. Fam. Code § 3.201(a)(2). A debt incurred for necessaries exposes the entire nonexempt marital estate (separate and community) to liability. Tex. Fam. Code § 3.202.

Note: Parents are legally obligated to support their children until the children attain the age of 18 or graduate from high school. Tex. Fam. Code § 154.001.

E. Spousal Necessaries Cases

1. *Approved Personnel Serv. v. Dallas*, 358 S.W.2d 150 (Tex. App.—Texarkana 1962, no writ) ("No case is cited holding a contract for services of the nature rendered here to be a necessary. There are numerous cases in which courts have, on the basis of facts of the particular case, held medical, dental and legal services to be necessaries. . . . The facts and circumstances of a case control and mold the meaning of the term as here used and the formulation of a comprehensive definition is difficult. Decision in this case must be made on the basis that the term encompasses such services as the husband is financially able to and should provide for the wife's benefit and that are suitable to the maintenance of the condition and station in life the family occupies").

2. *Finney v. State,* 308 S.W.2d 142 (Tex. Civ. App.—Austin 1957, writ ref'd n.r.e.) (court held deceased wife's estate liable for medical bills incurred by deceased

husband while he was a patient at three state facilities).

3. *Fleming v. Oring*, Civil Action No. 3:04-CV-1303-B, 2005 U.S. Dist. LEXIS 5062 (N.D. Tex. Mar. 29, 2005) (facts of case concern suit against husband for funds that caretakers spent in order to provide for basic needs of husband's wife; case was dismissed for lack of personal jurisdiction.)

4. *Jarvis v. Jenkins*, 417 S.W.2d 383 (Tex. Civ. App.—Waco 1967, no writ) (husband ordered to reimburse wife's attorney, who paid for her groceries and an airline ticket for her to travel to Virginia to visit family and seek medical treatment; items considered to be necessities).

5. *Turner v. Lubbock County Hospital District*, No. 07-96-0272-CV, 1998 Tex. App. LEXIS 53 (Tex. App.—Amarillo 1998, no pet.) (court found that as a matter of law, medical services are necessaries).

6. *White v. Lubbock Sanitarium Co.*, 54 S.W.2d 1058 (Tex. Civ. App.—Amarillo 1932, writ dism'd w.o.j.) (wife's medical expenses held to be necessaries; husband and wife found to be jointly liable for the medical debt).

<u>Note:</u> *The author's research discovered statements from various sources suggesting that once one spouse has qualified for Medicaid nursing care the other spouse no longer has any personal liability for the nursing care. The author appreciates Clyde Farrell confirming this general understanding of this complex set of Medicaid rules. Clyde also explained that, while the community spouse is still generally liable for other "necessaries," when the other spouse is in the nursing home, Medicaid covers most of the needs of the other spouse. If the other spouse is receiving Medicaid home care, Medicaid does not pay for "necessaries" other than medical care (including personal attendant care). However, for the purpose of this paper, it will be assumed that neither spouse has qualified for Medicaid nursing care.*

F. No Community Debt

The Texas Family Code's liability rules do not support the notion of a "community debt." *See Tedder v. Gardner Aldrich, LLP*, 421 S.W.3d 651 (Tex. 2013). That term suggests that (i) both spouses have personal liability for the debt and (ii) all non-exempt community property can be reached to satisfy the debt. Neither statement is necessarily true. Please also refer to *Marital Property Liabilities: Dispelling the Myth of the Community Debt*, State Bar of Texas, Advanced Estate Planning and Probate Course, June 2009, and the *Marital Property Liabilities: Dispelling the Myth of Community Debt*, Featherston and Dickson, *Texas Bar Journal*, January 2010.

G. Summary

Accordingly, absent a statutory exemption, a spouse's separate property and sole management 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 sole management community property is also liable for the debt (the other spouse's separate property may be exempt depending upon the circumstances).

If the debt is not a tort debt incurred during the marriage, the other spouse's separate property and sole management 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 sole management community and separate) is liable as well.

However, if the debt was incurred as a reasonable expense for the support of either spouse, each spouse has personal liability, and the entire nonexempt marital estate (each spouse's separate property and their community property) is liable.

H. Key Questions

The Texas Legislature has enacted a logical liability process that utilizes a multiple-step process to determine which nonexempt marital assets of a husband and wife are liable for which debts during the marriage. Texas courts are finally getting it right. *See Beal Bank v. Gilbert*, 417 S.W. 3d 704 (Tex. App.—Dallas 2013, no pet. h.). The process is dependent upon the answers to four questions:

1. When was the debt incurred? *It was incurred either prior to or during the marriage.*

2. Whose debt is it? *It is either the debt of the husband, the debt of the wife or both spouses' debt.*

3. What type of debt is it? *Was it tortious or contractual in nature? Or was it incurred for a "necessity"?*

4. If not a "necessity," was the spouse who incurred the debt acting as the other spouse's agent?

The ultimate answer depends on the relevant facts and circumstances and the specific answers to these four questions.

<u>Note:</u> *However, the statutory liability rules change when the first spouse dies. See V, infra.*

V. ADMINISTRATION OF DECEASED SPOUSE'S ESTATE

The purposes of a decedent's estate administration are to collect the assets of the estate, to pay the decedent's debts and to distribute the remaining assets to the decedent's heirs and/or devisees. In addition, the administration of a married decedent's estate may include the actual partition of the community probate property. As discussed previously, death works a legal partition of the community probate assets, but it is often necessary to open an administration to effectively set aside the homestead, exempt property and family allowance, handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees.

A. Section 453.009

During formal administration, the personal representative is granted authority to administer not only the deceased spouse's separate property but also what was the couple's joint community property and the decedent's sole management community property. The surviving spouse may retain possession of the survivor's sole management community property during administration or waive this right and allow the personal representative to administer the entire community probate estate. Tex. Est. Code § 453.009.

B. Authority of Representative

The authority of the personal representative over the survivor's one-half of the community should be limited to what is necessary to satisfy the debts of the deceased spouse properly payable out of such community assets even if the decedent's will purports to grant to the representative more extensive powers over the decedent's separate assets and one-half interest in the community.

C. Executor's Elective Power

However, if there is a will and the surviving spouse is a beneficiary of the will, the surviving spouse who accepts any benefits under the will may have elected to allow the executor to exercise more extensive powers over his or her share of the community assets during administration.

D. Comparing Family Code and Estates Code Provisions

The Estates Code's division of authority dovetails with the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's ability to step into the decedent's shoes and satisfy the deceased spouse's debts in most situations. *See* Tex. Fam. Code §§ 3.102 and 3.202.

1. <u>Contract Debts</u>

One hundred percent of the couple's joint management community property and the deceased spouse's sole management continue to be liable for the decedent's debts. However, if the deceased spouse's sole management community and the joint management community assets in possession of the personal representative and available to satisfy the deceased spouse's contractual creditors are insufficient for that purpose, Tex. Est. Code § 101.052 indicates that the deceased spouse's one-half interest in the surviving spouse's sole management community property can be reached to satisfy those creditors.

<u>Note</u>: *One hundred percent of the other spouse's sole management assets had been generally exempt from the claims of the deceased spouse's non-tortious creditors during the marriage (as well as any premarriage debts).*

2. <u>Tort Debts</u>

Prior to the deceased spouse's death, all nonexempt community property was liable for the tort debts of either spouse. Section 101.052 suggests that only the decedent's one-half interest in the surviving spouse's sole management community may continue to be liable for any tort debts of the deceased spouse. *In other words, the statutory language indicates that the surviving spouse's one-half interest in the survivor's sole management community is no longer liable for any tort debts of the deceased spouse.*

E. Authority of the Surviving Spouse

Generally, when a personal representative is administering the estate of the deceased spouse, including the surviving spouse's one-half of the decedent's sole management community and the couple's joint community, the surviving spouse's fiduciary authority over the survivor's sole management community property enables the survivor to exercise all the powers granted to the surviving spouse where there is no administration pending. Tex. Est. Code § 453.009. This statutory language suggests that the survivor can deduct from the special community being administered "necessary and reasonable expenses" and a "reasonable commission." The survivor shall keep a distinct account of "all community debts" allowed or paid. *See* Tex. Est. Code § 453.006.

Note: Like their predecessors in the Texas Probate Code, Sections 160 and 168, Texas Estates Code Sections 453.003 and 453.006 still refer to "community debts" and "community obligations," terms carried forward from pre-1967/1971 law; however, as Professor McKnight explained, a "community debt" or "community obligation" should be interpreted to mean nothing more than some community property, or a portion thereof, is liable for its satisfaction, the same meaning given by the Supreme Court in Tedder. See IV, infra.

F. Allocation of Liabilities after Death

1. Probate Assets

As pointed out previously, the Texas Estates Code's division of authority tracks the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's ability to step into the decedent's shoes and satisfy primarily the deceased spouse's contractual debts, but it does not specifically address the debts of the surviving spouse which are not debts of the deceased spouse. It also does not address the order in which assets subject to administration are liable for which debts.

2. Nonprobate Assets

In the past, many believed in the "urban myth": probate assets pass subject to the decedent's debts whereas nonprobate assets pass to their designated beneficiaries, free of the decedent's debts. Today, the statutory rules negate the application of that myth. *See* Tex. Est. Code §§ 111.053, 113.252, 114.106. *See also* V, C, *supra*.

3. General Power Theory

Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a general power of appointment would seem broad enough to capture most nonprobate dispositions, including joint tenancies and revocable trusts, within its coverage and, thereby, subject the property in question to the liabilities of the donee of the power, either during the donee's lifetime or at death, unless there is a specific statutory exemption. In *Bank of Dallas v. Republic National Bank*, 540 S.W. 2d 499 (Tex. Civ. App.—Waco 1976, writ ref'd n.r.e.), the court explained, "If the settlor reserves . . . a general power (the power to appoint to the settlor) . . ., his creditors can reach the principal." A general power includes the ". . . authority to alter, amend or revoke. . . ." Tex. Prop. Code § 181.001(2).

4. Abatement Generally

Despite the growing need for a comprehensive statute which would complement Sec. 111.053 of the Texas Estates Code and define the rights of creditors in and to the probate and nonprobate assets of a deceased debtor, the Legislature has only codified the order in which property in the probate estate would be liable for debts and expenses properly chargeable to the probate estate. Tex. Est. Code § 355.109.

5. Abatement Among Community and Separate Assets

Sec. 355.110 of the Texas Estates Code directs a representative to pay the deceased spouse's *funeral expenses* out of the decedent's separate and one-half of the community, but Sec. 355.109 fails to give directions on how to pay the deceased spouse's debts. Sections 101.052 and 453.009 explain which of the deceased spouse's property remains liable for the debts. The potential for a conflict of interest is obvious; the expenditure of separate funds to satisfy a debt will inure to the benefit of the surviving spouse while using community funds would accrue to the benefit of the decedent's estate. Presumably Sec. 3.203 of the Texas Family Code would be relevant, and the facts and circumstances surrounding the source of the debt should be considered. For example, is it a purchase money indebtedness? Is it tortious or contractual in nature?

6. General Guidelines

The author is not aware of any definitive cases on point that offer any clear guidance. Accordingly, it is the author's opinion that certain claims should be paid out of the decedent's separate property or the decedent's one-half of community assets. These claims would include funeral expenses, separate property's purchase money indebtedness, and tort claims against the decreased spouse only. Other claims, like debts incurred for living expenses (e.g., credit cards and utilities), or for community property purchase money indebtedness, should be paid out 100% of the community property under administration.

Note: If there is a will, language in the will may direct the executor to pay the decedent's debts out of the decedent's "residuary estate." This may be interpreted to require the executor to pay any and all debts for which the deceased spouse had personal liability out of the deceased spouse's separate property and one-half of the community. Absent that language, certain debts should be paid out of both halves of the community property under administration.

G. 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.

Assuming that the decedent's one-half community interest has been left to someone other than the surviving spouse, the respective ownership interests of the survivor and the decedent's distributees are subject to the possessory rights of either a court appointed personal representative or the surviving spouse for administration purposes. When administration is completed, the survivor and the distributees are generally entitled to their respective undivided one-half interests in each and every community probate asset. Tex. Est. Code § 101.001.

Note: A non-pro rata distribution of the community following the first spouse's death is a frequent topic of discussion, but beyond the scope of this paper.

H. The Phantom Estate

If the deceased spouse's separate property and the deceased spouse's interest in their community property passed nonprobate, and/or the only probate type assets remaining were the surviving spouse's sole management community property, Section 453.009 indicates that the personal representative would not have any property to administer unless the surviving spouse waives the right to retain possession of what was surviving spouse's sole management community property, an unlikely event.

1. Debts

Section 101.052 states that the deceased spouse's one-half interest in what was the surviving spouse's sole management non-exempt community property is still liable for the deceased spouse's debts. Section 111.053 indicates that any nonprobate assets which were the deceased spouse's separate property or sole management community property, as well as the couple's joint management community property, remain liable for the decedent's debts absent an applicable statutory exemption.

2. Administration

Absent a specific statutory process, like for community property with rights of survivorship, multi-party accounts and transfer of death deeds, is there an estate for a personal representative to administer? Must the creditors of the deceased spouse who are creditors of the surviving spouse pursue their claims against the surviving spouse or the beneficiaries of the nonprobate assets? Does an executor or administrator have the authority to pursue from the surviving spouse what was the deceased spouse's one-half interest in the surviving spouse's sole management community property in order to pay the deceased spouse's debts? Does the representative have the authority to pursue the nonprobate assets that have already passed to the beneficiaries?

If so, what is the representative's cause of action against the surviving spouse? *Perhaps a partition?* Absent one of the statutory processes mentioned above, what is the cause of action against the nonprobate beneficiaries? *Perhaps a constructive trust?*

3. Spouse as Beneficiary

If the surviving spouse is the sole beneficiary of the deceased spouse's estate, or for whatever reason wishes to cooperate with the deceased spouse's heirs and /or devisees, waiving the right to retain possession of what was the surviving spouse's sole management community property and allowing the surviving spouse or someone else to administer that property would add some certainty to the administration of the community estate.

VI. CLOSELY-HELD, FAMILY ENTITES

The use of modern business entities, such as corporations, partnerships and limited liability companies, has become an integral part of family estate planning. The appendix to this article is an overview of general entity and marital property concepts while this particular section of the outline initially focuses on family limited partnerships. For an excellent and complete discussion of the intersection of marital property law and business organizations, see "Dividing Ownership Interests in Closely-Held Business Entities: Things to Know and Avoid" by Patrice Ferguson, Richard R. Orsinger and Bryan Polk 2016, State Bar of Texas Advanced Family Law Course.

A. Entity Theory

Under normal circumstances, the assets contributed to the partnership become the assets of the partnership, and the partners receive partnership interests. Accordingly, 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 generally do not take on a separate or community character. 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).

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.2d 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 as really being liquidating distributions or partial payments for the partnership itself. See Jack Marr, *Business and Divorce*, 34th Annual Marriage Dissolution Institute (2011). See also *Texas Practice, Business Organizations*, Miller and Ragazzo, Sec. 9:3 (West 2011).

C. Comparison to Corporations

Partnerships, limited partnerships, limited liability partnerships and limited liability companies are treated as entities under Texas law like corporations. 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 generally award specific entity assets to the other spouse. *Gibson v. Gibson,* 190 S.W. 3d 821 (Tex. App.—Ft. Worth 2006, no pet.).

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 dism'd w.o.j.); *Spruill v. Spruill*, 624 S.W.2d 694 (Tex. App.—El Paso 1981, writ dism'd w.o.j.); *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Ft. Worth 1968, writ dism'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 *Robbins v. Robbins*, 727 S.W.2d 743, 747 (Tex. App.—Eastland 1987, writ ref'd n.r.e.), proof that a spouse dominated the corporate affairs of a substantially separately owned corporation while working long hours did not establish the "unity" with the corporation to negate the separate existence of the corporation.

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. Texas Pattern Jury Charge

The Texas Pattern Jury Charges provide that the distinct corporate identity of a corporation may be disregarded if there is unity between the corporation and a *shareholder* so that the separateness of the corporation has ceased and the improper use of the corporation has damaged the community estate. The corporate identity may be disregarded even though the corporate formalities have been observed and corporate assets have been kept separated from individual property. *See* Texas Pattern Jury Charges, 205.1, 205.2 (2018).

F. Veil Piercing of Other Entities

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.

G. Sole Proprietorships

Continuing to operate the family "business" brought into a marriage, or established with separate funds during marriage, 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 separate property. In *Allen v. Allen*, 704 S.W.2d 600, (Ft. Worth 1986, no writ), a spouse was operating a sole proprietorship at the time of the marriage. She later converted the business into a corporation, essentially continuing the business activities after the conversion as she had prior to the marriage. At the time of divorce, her shares in the corporation were found to be community property since she could not prove by clear and convincing evidence that the source of the initial capitalization of the corporation came from her separate property.

H. Personal Goodwill

Personal goodwill (i.e., goodwill that accrues to an individual and that is not separate and apart from that individual's person is not property, and therefore it cannot be community property). *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972) (an unincorporated professional practice); *Greesbreght v. Greesbreght*, 570 S.W.2d 427 (Tex. Civ. App.—Ft. Worth 1978, writ dism'd) (a professional medical corporation). Texas Pattern Jury Charges PJC 203.2 (2018).

I. General Partnership Formation

Some commentators have taken 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.).

J. Community Opportunity Theory

The argument described above is that a general partnership is created at the time of the partners' "handshake" rather than at the time the partnership agreement is signed. Thus, the individual partner's interest in the partnership becomes property at that time and is likely to be community property under the inception of the rule since 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.

<u>Note</u>: The better view, in the author's opinion, 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.

K. Loans to and From Entities

The books and records of the entity may reflect a loan by the entity to a spouse/owner (i.e., a distribution to the spouse but not in the form of compensation or distributed profits). If the funds received by the spouse were actually borrowed, the funds are community property absent an agreement that the entity agreed to look only to the spouse's separate property for repayment. The marital property character of a loan repayment by the entity to the spouse/owner should depend on whether the spouse loaned traceable separate property or community property. Interest on the loan is community property.

VII. IRREVOCABLE TRUSTS

The private express trust is a unique concept and one that is frequently misunderstood by members of the public and practitioners alike. The common law established that the trust is not an entity; it cannot own property; it cannot incur debt. Although it may be treated as if it were an entity for some purposes, it remains today a form of property ownership. *See* Tex. Trust Code § 111.004(4). Certain other common law principles remain relevant today. For example, a person serving as trustee is not a legal personality separate from such person in his or her individual capacity. A person serving as trustee is not the agent of either the trust, the trust estate or the beneficiaries of the trust. Finally, the trust assets are not considered to be the property of the person serving as trustee; such assets belong in equity to the beneficiary. These principles can affect the marital property rights of the parties.

A. The Private Express Trust

One noted authority describes the private express trust as ". . . a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique. . . . The purposes for which trusts can be created are as unlimited as the imagination of lawyers." III, IV, *Scott on Trusts* (3d. ed. 1967).

1. <u>Definition</u>

A trust, when not qualified by the word "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of the intention to create the relationship. Tex. Trust Code § 111.003.

2. <u>Creation</u>

According to Section 112.002 of the Texas Trust Code, a trust may be created by: (i) a property owner's declaration that the owner holds the property as trustee for another person; (ii) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (iii) a property owner's testamentary transfer to another person as trustee for a third person; (iv) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or (v) a promise to another person whose rights under the promise are to be held in trust for a third person.

3. <u>Revocable or Irrevocable</u>

Inter vivos trusts are further divided into two categories: revocable and irrevocable. A revocable trust is one that can be amended or terminated by the settlor. An irrevocable trust, in contrast, is one that cannot be amended or terminated by the settlor for at least some period of time. The presumption regarding the revocability of inter vivos trusts varies by jurisdiction. For example, in Texas all inter vivos trusts created since April 19, 1943, are revocable unless the trust document expressly states otherwise; while in some other states, trusts (including Texas trusts created prior to April 19, 1943) are deemed irrevocable unless the trust document states otherwise. Tex. Prop. Code Ann. § 112.051.

<u>Note</u>: *If the trust is revocable, it is deemed "illusory" (technically an "illusory transfer") and is effectively ignored for marital property purposes (i.e., the "trust veil" is pierced). See Land v. Marshall, 426 SW.2d 841 (Tex. 1968). See VIII, A, infra.*

B. Beneficial Ownership

While record legal title to the assets of the trust is held by the trustee, equitable title — true ownership — belongs to the beneficiaries. For example, trust law generally exempts the assets of the trust from any personal debt of the trustee not related to the administration of the trust. This exemption even applies if the trust property is held by the trustee without identifying the trust or the beneficiaries. The rationale behind this exemption is the concept that the assets of the trust really belong to the beneficiaries. *See* Tex. Prop. Code § 101.002 and Tex. Trust Code § 114.0821. These principles confirm that trust assets belong to the beneficiaries and not the trustees. Accordingly, a trustee's spouse generally does not acquire any marital property interest in trust property, but spouses of the beneficiaries may, depending on the circumstances.

Note: If a married trustee wrongly converts trust property that is not subsequently recovered by the beneficiaries, the converted trust property is the couple's community property since it was not acquired by gift unless, perhaps, it is shown by clear and convincing evidence that the beneficiaries' failure to pursue their claim against the trustee was due to their donative intent.

C. Interests of the Settlor's Spouse

The creation and funding of an irrevocable inter vivos trust by a settlor may or may not remove the trust assets from the reach of the settlor's spouse when the marriage terminates. If (i) the trust is irrevocable and (ii) the settlor has not retained an equitable interest in the trust estate, the assets of the trust really belong to the beneficiaries and no longer have either a separate or community character insofar as the settlor's spouse is concerned.

Note: If the transfer of community assets in order to fund the trust is found to have been in fraud of the community, the settlor's spouse may be able to reach the assets of the trust like any other assets transferred to a third party, free of trust, but in fraud of the community interests of the wronged spouse. See Tex. Fam. Code § 7.009.

D. Settlor's Retained Interest

If the settlor creates an irrevocable trust and retains a beneficial interest in the trust assets, the rights and remedies of the settlor's spouse would appear to be similar to the rights of the settlor's creditors. Creditors can generally reach the maximum amount that the trustee can pay or distribute to the settlor under the terms of the trust agreement, even if the initial transfer into the trust was not in fraud of creditors.

1. Retained Income, General Power.

For example, if the settlor retains an income interest in the trust assets for the rest of the settlor's life, creditors can reach the retained income interest, and if the settlor retains a general power of appointment over the entire trust estate, creditors can reach the entire trust estate. *See Bank of Dallas v. Republic Nat. Bank of Dallas*, 540 S.W.2d 499 (Tex. Civ. App.—Waco 1976, writ ref'd n.r.e.).

2. Retained Income, Principal

If the settlor retains an income interest for the remainder of the settlor's lifetime, the creditors can reach the income interest, but not the fixed remainder interest already given to the remainder beneficiaries. If the trustee has the discretion to invade the principal for the settlor, the extent of the settlor's retained interest may be the entire trust estate. *See Cullum v. Texas Commerce Bank Dallas, Nat. Ass'n.*, 05-91-01211-CV, 1992 WL 297338 (Tex. App.—Dallas Oct. 14, 1992) (not designated for publication).

3. Spendthrift Provision

The inclusion of a spendthrift provision in the trust document does not insulate the settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035 and *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).

4. Marital Property Issues

If the self-settled trust was funded with the settlor's separate property, the application of these creditor principles in the marital property context would suggest that any income generated by the trust estate may still be deemed community property if the settlor retained an income interest in the trust. Any income actually distributed to the settlor should be community property whether it is mandated by the terms of the trust or at the discretion of the trustee.

5. Undistributed Income

However, where the trust was funded with the settlor's separate property prior to marriage and the trustee was a third party who had discretion to make income distributions to the settlor, the trustee's discretion prevented the trust's income from taking on a community character until the trustee exercised its discretion and distributed income to the settlor. The wife in a divorce action had claimed that all of the trust assets were community property since the income generated during the marriage had been commingled with the trust corpus. *See Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App.—Fort Worth 1996, writ denied) and *Matter of Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.—Texarkana 1978, writ dism'd w.o.j.). In *Burns,* one of the trusts was created during the marriage. Some older cases support that same result. *See Shepflin v. Small,* 4 Tex. Civ. App. 493, 23 S.W.432 (1893, no writ) and *Monday v. Vance,* 32 S.W. 559 Tex. Civ. App. 1895 no writ).

Note: This line of thought suggests that, if an irrevocable trust is self-settled prior to, or during that marriage with separate property, any distribution of income to the settlor spouse may still be community property. Whether any undistributed income is community property may still depend on the terms of the trust, the identity of the trustee who has the power to make income distributions, and the nature of any retained powers by the settlor spouse in either a fiduciary or individual capacity.

6. Community Funding

If the trust was funded with community property without the consent of the other spouse, the other spouse could challenge the creation and funding of the trust as being in fraud of the community. Had the property contributed to the trust been subject to their joint management, the other spouse could argue that the transfer of such assets was void since the other spouse did not join in the transfer. If the settlor retains a general power of appointment, the other spouse could argue that the transfer of community property into the trust was "illusory" as to her community interests similar to the result in *Land v. Marshall. See* VIII, A, *infra.*

Note: Accordingly, the only safe conclusion to reach is that the proper application of marital property principles should depend on the nature and extent of any retained interest or power and perhaps the timing of the creation of the trust.

E. Interests of the Non-Settlor Beneficiary

Because a beneficiary of a trust owns a property interest in the trust estate created by a settlor who is not the beneficiary, the ability of the spouse of the beneficiary to establish a community interest in certain assets of the trust or its income should depend on the nature of the beneficiary's interest and any powers granted to the beneficiary. Equitable interests in property, like legal interests, are generally "assignable" and "attachable," but voluntary and involuntary assignees cannot succeed to an interest more valuable than the one taken from the beneficiary. A general inter vivos power may give the beneficiary the “equivalence of ownership.”

1. Comparison to Creditors' Rights

Again, a review of the rights of creditors of the beneficiary appears relevant. For example, if the beneficiary owns a remainder interest, a creditor's attachment of the beneficiary's remainder interest cannot adversely affect the innocent life tenant's income interest. On the other hand, if the beneficiary is only entitled to distributions of income at the discretion of the trustee for the beneficiary's lifetime, a creditor of the beneficiary cannot attach the interest and require the trustee to distribute all the income. In fact, a creditor may not be able to force the trustee to distribute any income to the creditor since it would infringe on the ownership interests of the remaindermen. But, if it is a spendthrift trust, see V, E. *infra.*

2. Principal

Assuming donative intent on the part of the settlor, the original trust estate (and its mutations and income generated prior to marriage) clearly is the beneficiary's separate property as property acquired by gift, devise or descent, or property acquired prior to marriage. Distributions of principal are likewise the beneficiary's separate property as a traceable mutation of the gift or devise. *See Hardin v. Hardin*, 681 S.W.2d 241 (Tex. App.—San Antonio 1984, no writ).

3. Distributed Income

If the discretionary income beneficiary is married, it would logically follow that distributed income should be considered separate. The exercise of discretion by the trustee, in effect, completes the settlor's gift to the beneficiary. The result may be different if the beneficiary is the trustee or can otherwise control the distributions.

Note: If income distributions are limited to an ascertainable standard, such as health, education, maintenance or support, see V, G, 3, infra.

4. Split Authority

On the other hand, if the trustee is required to distribute the trust's income to the married beneficiary, the income could be considered community once it is distributed since it arguably could be considered income from the beneficiary's equitable separate property. *See Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.—Corpus Christi 1997, no pet.). However, there is case authority that holds that trust income required by the trust document to be distributed to the beneficiary is the beneficiary's separate property, at least where the trust was created prior to the marriage. *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App.—Tyler 1996, no writ). *See also Matter of Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ), and *Wilmington Trust Co. v. United States*, 753 F.2d 1055 (5th Cir. 1985).

But see Sharma v. Routh, V, G, infra.

5. Undistributed Income

Undistributed income is normally neither separate nor community property. It is trust property. *See Matter of Marriage of Burns, supra; Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.—Fort Worth 1967, writ dism'd w.o.j.), and *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd). However, if the beneficiary has the right to receive a distribution of income but does not take possession of the distribution, such retained income may create marital property rights in the beneficiary's spouse. *See Cleaver, supra*. Depending on the intent of the beneficiary in allowing the distribution to remain in the trust, such income (and income generated by the retained income) may be considered to have taken on a community character or may be considered to have been a transfer to the other beneficiaries of the trust and subject to possible fraudulent transfer on the community scrutiny.

F. Spendthrift Trust

Texas law permits the settlor of a trust to prohibit both the voluntary and involuntary transfer of an interest in trust by the beneficiary prior to its actual receipt by the beneficiary. In fact, the settlor may impose this disabling restraint on the beneficiary's interest by simply declaring that the trust is a "spendthrift trust." Such a restraint is not effective if the beneficiary has a mandatory right to a distribution, but simply has not yet accepted the interest. Further, such a restraint is not effective to insulate a settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035.

<u>Note</u>: *This rationale suggests that the settlor's intent as to the nature of the beneficiary's interest may be relevant in determining whether the beneficiary's spouse acquires a community interest in the trust estate, the undistributed income or any distributed income. See Taylor v. Taylor, 680 S.W. 2d 645 (Tex. App.—Beaumont 1984 writ ref'd n.r.e.).*

G. Powers of Appointment

If the beneficiary has the absolute authority under the trust agreement to withdraw trust assets or to appoint trust assets to the beneficiary or the beneficiary's creditors, the beneficiary is deemed to have the equivalence of ownership of the assets for certain purposes. For example, such beneficiary would appear to have such an interest that cannot be insulated from the beneficiary's creditors by either the non-exercise of the power or a spendthrift provision. An appointment in favor of a third party could be found to have been in fraud of creditors. *See Bank of Dallas, supra*.

1. <u>Spouse with General Power</u>

While inconsistent with the common law, which treated the assets over which a donee had a general power as belonging to others until the power was exercised, application of this modern view may treat the assets over which a married donee has a general power as the separate property of the donee, but any income generated by those assets may be community property.

2. <u>Lapse of Powers</u>

If the beneficiary allows the withdrawal power to lapse, can the creditors still go after that portion of the estate that could have been withdrawn or can the beneficiary's spouse claim either a possible community interest in the assets allowed to continue in trust, or the income thereafter generated? In other words, does the lapse of the power make the beneficiary "a settlor" of the trust? The Legislature has answered some of these questions. Section 112.035 of the Texas Trust Code was amended by the Legislature in 1997 to confirm that a beneficiary of a trust is not to be considered a settlor of a trust because of a lapse, waiver or release of the beneficiary's right to exercise a "Crummey right of withdrawal" or "Five or Five" power.

3. <u>Ascertainable Standard Limitation</u>

If the beneficiary's power of withdrawal is limited to an ascertainable standard (i.e., health, support, etc.), creditors who provided goods or services for such a purpose may be able to reach the trust estate, but not other creditors. For a discussion of marital property issues, see *Sharma v. Routh*, V, H, *infra.*

Note: If income is distributed for such purposes to the spouse, but not so expended, such income should be community property since it was not acquired by gift or devise—the "rule of implied exclusion." See Texas Pattern Jury Charges PJC 202.3 (2018).

4. Non-General Powers

A beneficiary's power to appoint only to persons other than the beneficiary, the beneficiary's creditors and the beneficiary's estate are generally deemed personal to the beneficiary and not attachable by the beneficiary's creditors. It would also follow that such a power would not give the spouse any interest in the trust estate. However, if the power is exercised to divert community income from the beneficiary, could it be subject to possible fraud on the community scrutiny?

5. Special Powers

Many beneficiaries are given limited general powers (i.e., "Crummey" and the so-called "Five or Five" power, both of which permit the beneficiary to withdraw a certain amount from the trust estate at certain periods of time). *See* Tex. Trust Code § 112.035.

H. Sharma v. Routh

In this author's opinion, the court in *Sharma v. Routh*, 302 S.W.3d 355 (Tex. App.—Houston [14th Dist.], 2009, no pet.) offers a well-reasoned approach to the characterization of the income of non-self-settled trusts. The opinion includes an excellent review of Texas marital property law and previous trust income characterization cases. *See also Benavides v. Mathis*, 433 S.W. 3d 59 (Tex. App.—San Antonio 2014, no pet. h.).

1. Wife #1's Death

In the *Sharma* case, *Husband* and Wife #1 had accumulated a large community estate. When Wife #1 died, her will created classic QTIP and bypass trusts for Husband, naming him as the trustee of both trusts. The terms of the QTIP trust mandated that the trustee/Husband distribute the trust's income to himself; principal could be distributed if needed for his health, maintenance or support. The bypass trust authorized the trustee/Husband to make distributions to himself of income and principal as needed for his health, maintenance or support.

2. Second Marriage and Divorce

Husband later married Wife #2. Prior to and during that marriage, he received the income from the QTIP trust. Because of his individual wealth (his half of the community estate from the first marriage and his personal earnings as a physician), he never needed, nor did he ever receive, distributions of income from the bypass trust or the principal of either trust. During the divorce proceedings with Wife #2, she claimed that the income from both trusts, distributed and undistributed was their community property.

3. Court's Holding and Rationale

The court held that, based on the facts and circumstances existing during the second marriage, the income of both trusts, distributed and undistributed, was not community property; therefore, it was not subject to division by the divorce court. Even the income distributed to the Husband from the QTIP trust was his separate property. The undistributed income in the bypass trust was, in effect, neither community nor separate property, but still trust property. The key factor as to both trusts was that, under the actual facts, the Husband never *had a* *presently exercisable right* to the principal of either trust.

4. The Unanswered Questions

In *Sharma*, the husband never had a right to the principal of either trust due to his individual financial situation. But what if he would have? What if, in a particular year, he would have needed a principal distribution of ten percent of the value of the trust estate of a particular trust for his health, support or maintenance, would the court have found that ten percent of the income for that year was community property or would it rule that all of the income for that year was community property? Would it depend on whether income was actually distributed or accumulated? Presumably, whether its limited to ten percent or not, the relevant facts in one year should not fix the character for future years.

I. Annuity Trusts

If the spouse's interest in a non-self-settled trust is defined to be a distribution of a fixed percentage of the trust estate, like in a charitable remainder annuity trust or unitrust, the actual distribution by the trustee to the spouse may include both income and principal from a trust accounting perspective. So, once delivered to spouse, is the distribution community property or separate property? One argument is that the distribution, whether trust income or principal, or both, is separate property because that was the settlor's gift to the spouse beneficiary. However, the rationale of *Sharma* might suggest that a proportionate part of any distribution is community property to the extent it is trust income. In this author's opinion, the former analysis is the better analysis.

<u>*Note*</u>*: The analysis might differ if the trust was self-settled; in that situation, if funded with community property, any such distributions should be community property. If funded with separate property, the distribution is presumptively community property and the settlor spouse/ beneficiary may have to prove by clear and convincing evidence which portion is a return of the separate property contributed to the trust or its traceable mutation.*

VIII. REVOCABLE TRUSTS

If community property or separate property is used to fund a revocable trust, the relative marital property rights of the spouses could be adversely affected.

A. *Land v. Marshall*

In *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 was not able to prove that the funding of the trust was a fraud on the community. However, the Texas Supreme Court held that the husband's creation of a revocable trust with community property subject to his management and control 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.

Though <u>*Land*</u> *is a "death" case, the logical extension of that concept is that the trust structure can be ignored and the "trust veil" is pierced. Thus, the entire trust estate is presumptively community property if the marriage terminates in divorce.*

<u>*Note*</u>*: If the husband in* <u>*Land*</u> *had unilaterally attempted to transfer community property subject to their joint control into the*

trust under Tex. Fam. Code § 3.102, it is arguable the entire transaction may have been avoidable by his wife as a matter of law.

B. Other Funding Issues

Depending on the wording of the documentation at funding, joint funding by both spouses of a revocable trust could be a partition of community property under Section 4.102 of the Texas Family Code resulting in separate property interests which would affect its division at divorce and the income tax basis at death. A commingling of community and separate funds upon funding or during administration could risk losing the separate character of any separate property placed in the trust, thereby exposing the entire trust estate to the claims of either spouse's creditors and to an "equitable division at divorce.

The terms of the trust or its administration could convert one spouse's retained equitable interest in his or her sole management community property into their joint community property, which could improve any rights of their creditors. Sole management community property of one spouse is generally not liable for the contractual debts of the other spouse. Tex. Fam. Code §3.202.

C. Separate Property Funding

If a spouse creates and funds a revocable trust prior to marriage or during marriage with separate property, *Land v. Marshall* and *Sharma v. Routh* both suggest that any trust income generated during marriage, whether distributed or undistributed, is community property. The power of revocation creates an "illusory trust" for marital property purposes as described by the court in *Land*. That power of revocation is effectively a general power of appointment (that is, a presently exercisable right to principal) as described in *Sharma*. In a corporate setting, the entity would be described as the owner's "alter ego" by reason of the court applying the concept of "reverse veil piercing." Accordingly, upon termination of the marriage in a revocable trust situation, it logically follows that the trust estate (undistributed income and existing principal) would be presumptively community property, and the settlor spouse would need to prove by clear and convincing evidence the separate character of the existing principal of the trust estate.

D. Community Property Basis

Because a deceased spouse's interest in the revocable trust assets is included in the deceased spouse's gross estate for estate tax purposes, the deceased spouse's interest will receive a new income tax basis. If the assets are still community property, the surviving spouse's interest also receives the basis adjustment. IRC § 1014(b).

IX. CHANGE OF DOMICILE

When a married couple moves from a community property state to a common law state, the change of domicile complicates their relative marital property rights. A few general rules do exist, including the law of the situs governs interests in land. Restatement (Second) of Conflict of Laws § 234 (1971). A change of domicile does not generally change the property interests of the spouses in real property. Gerald Treacy, *Tax Management Estates, Gifts and Trusts Portfolio*, 802-2nd, Community Property: General Considerations (BNS). *See also* Restatement (Second) Conflict of Laws § 234 (1971). For "movables," *see* Restatement (Second) Conflicts, §§ 258-259. But the real question is whether the couple's community property is still community after the move, or do they just maintain their respective ownership interests, but as tenants in common or joint tenants?

On the other hand, the attributes of ownership associated with the community property acquired by the couple while domiciled in a community property state do not necessarily stay the same after they move to another state. Some noted commentators are more optimistic that the community property status of the couple's assets can be maintained even after a move to a common law state. *See* Dukeminier, Sitkoff and Lindgren at pages 513-514. The bottom line is that there is very little definitive law!

A. General Conflicts Principles

Traditionally, the law of the state in which real property is located determines its ownership, and the law of the marital domicile determines the ownership of personal property. A married couple's move between a community property and common law state should not affect the *ownership of the assets* already acquired. Susan Gary, Jerome Borison, Naomi Cahn, Paula Monopoli, *Contemporary Approaches to Trusts and Estates*, 610 (2^{nd} Ed. 2014). *See*, also, Kenneth W. Kingma, *Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States*, 35 ACTEC J. 74 (2009).

B. Unique Features

While they were domiciled in the community property state, not only did the couple have equal, undivided ownership interests, but the community property state's unique set of rules governing management and liabilities related to the property attached. Upon the termination of the marriage, the community property state's unique set of rules would have governed the dissolution of this unique type of marital partnership.

C. Attributes of Ownership

To be sure, the property that was originally community property, whether held in his name, her name or their names, and whether it was real or personal property, should still be owned in equal, undivided interests by the spouses after they move. But to assume that the same "attributes" of ownership that attached while they were domiciled in the community property state (i.e., management, liabilities, effect of dissolution) still apply once their domicile changes is problematic (even if it is a move from one community property state to another community property state). Surprisingly, there are relatively few cases addressing the attributes of ownership, and even among those, the results are not always consistent. See Exhibit A, attached Green and Gold Acres.

D. Real Property

If a tract of land was community property in a community property state, after the change of domicile, both spouses still own an undivided one-half interest, even though title may be in one spouse's name, but do the community property state's rules of management and liability still apply? If they later divorce, does the common law state divide the property using its own rules or the community property state's rules? If the marriage ends in death while they live in the common law state, the disposition of the deceased spouse's interest in the real property is clearly governed by the law of the situs, but there still exists numerous ancillary issues, the resolution of which will depend on which state's law applies, the law of situs or the law of domicile.

E. Personal Property

The effect on the characterization of personal property when the couple moves from a community property state to a common law state depends on the law of the state having the most significant contacts, typically the state of the current domicile. The approach taken by some states appears to preserve the community character of any "movables" at least until the couple takes some kind of action that is inconsistent with community property principles. In those states, it is unclear how the new state of domicile will treat the unique attributes of community ownership that existed prior to the change of domicile. *See* Reppy, Samuel and Richardson, *supra,* pgs. 437-440. In fact, a critical review of the cases in those states suggests that the property that is called community property by the court may not be community property.

Ladd v. Ladd, 580 S.W. 2d 696 (Ark. 1979) has been cited as authority that land in Arkansas purchased by a couple who moved from New Mexico to Arkansas with the proceeds of the sale of land in New Mexico was community property. However, the Arkansas court simply held that the wife was entitled to her one-half interest in what her husband had purchased in Arkansas with what had been community property in New Mexico. The court even refers to the "source of payment" doctrine followed by a majority of states and cites cases in Missouri and California. *See also Edwards v. Edwards,* 233 P. 477 (Okla. 1924).

People v. Bejarano, 358 P.2d 866 (Colo. 1961) is frequently cited as authority that Colorado recognizes that transported community property remains community property under Colorado law, even after the couple moves to Colorado. However, the Colorado Supreme Court's actual holding is the recognition of the surviving spouse's one/half ownership interest in what was community property following the couple's move to Colorado and her husband's subsequent death. The same analysis can be made of perhaps the leading case cited for that argument that transported community remains community property in some common law states, *Commonwealth v. Terran*, 90 S.E. 2d 801 (Va. 1956). *See also In re Kessler Estate*, 203 N.E. 2d 211 (Ohio 1964).

Similarly, a Missouri case is cited to support the same argument, but its actual holding is that that personal property located in Missouri owned by a decedent domiciled in Texas was the community property of the decedent and his spouse under Texas law. Personal property is governed by the law of the domicile. *In re Estate of Perry*, 480 S.W.2d 893 (Mo. 1972).

<u>Note</u>: *After the cited cases were decided, Virginia and Ohio, as well as Colorado, enacted the Uniform Act (see IX, F, <u>infra</u>), which codifies the majority view, the source of payment/resulting trust approach, not the maintained "community property" rule.*

When a couple moved from Texas to Iowa and later divorced, an Iowa court was asked whether a cash management account that was left behind in Texas was to subject to division by an Iowa divorce court. The court explained that Texas law should be used to determine the respective ownership interests of the spouses in the account that had been opened while they were living in Texas and maintained there after the move to Iowa. However, Iowa law determined its marital property status for its division by the Iowa divorce court. *See In re Marriage of Whelchel*, 476 N.W.2d 104 (Court of Appeals Iowa (1991).

On the other hand, the law in most common law states appears to convert the transported "movables" into some form of common law ownership. In the often-cited case for the majority view, *Quintana v. Ordono*, 195 So. 2d 577 (Fla. App. 1967), the court explained that a wife's vested interest in community property stock was not affected by the couple's change of domicile from Cuba to Florida. But to reach that result, the court relied on Florida's common law concept of a resulting trust. The court did not hold the property was community property; the property was now held in a common law form. It still reached a result that maintained both spouses' respective ownership interests.

<u>Note</u>: The bottom line is the answer depends on the law of the new domicile. But it is generally accepted that each spouse retains his or her vested one-half interest in what was their community property when the couple moves to a non-community property jurisdiction. See Reppy, Samuel and Richardson, supra, pages 437-440. There is certainly no consensus that the transported property is still community property.

F. "UDCPRDA"

A number of states have adopted the Uniform Disposition of Community Property Rights at Death Act (1971) ("the Uniform Act"), which causes what was community property, or what is traceable to what was community property, to be treated as though it were still "community property" at the death of the first spouse. The Uniform Act has very limited application; it does not preserve the property's community character. It actually only codifies the above described majority view by preserving the surviving spouse's one-half interests in what was community property after the couple moved to an enacting state. It was not intended to have any effect on the rights of creditors, the spouses themselves or other persons prior to a spouse's death. The Uniform Act has been enacted in Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia and Wyoming. *See* Reppy, Samuel and Richardson, *supra*, pgs. 440-443.

G. IRC § 1014(b)(6)

The most significant estate planning consequence of the approach taken by the common law state may be whether both spouse's respective interests in any transported personal property will receive an adjusted basis under IRC § 1014(b)(6) at the first spouse's death. If the law of the new domicilary state actually preserves the community character of the assets, it would appear that IRC § 1014(b)(6) should apply. The result is not clear in a state that applies the majority rule or has enacted the Uniform Act. While there is some authority that the IRS will allow the "step-up" for the surviving spouse in those states, there is no definitive answer and leading authorities are divided in their opinions. *See* Jeremy Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 3 Nev. L.J. 704, 713 (2005) (where the author also discusses steps a couple may attempt to utilize in order to preserve the community character of their personal property. *Supra*, p. 719).

H. Law of Domicile – Effect on Situs

Whether the surviving spouse's one-half of the real property still owned and located in the community property state after the change of domicile receives the § 1014(b)(6) adjustment in basis should depend on whether it is still "community property" under the law of the situs state. A key factor to reaching that conclusion is determining the relevance of the law of the state where the couple is or was domiciled.

In that context, *Hammonds v. Commissioner of Internal Revenue*, 106 F.2d 420, 424 (10th Cir. 1939), a federal income tax case, the court noted that, in community property states, marital rights in land are generally regulated by the law of the situs regardless of the domicile of the couple. There the couple lived in Oklahoma and the wife acquired an interest in Texas oil and gas leases in exchange for services rendered. If common law principles applied, the leases would be her separate property; if Texas law applied, under Texas community property law, the leases would be their community property. The court applied Texas law and quoted *Heidenheimer v. Loring*, 6 Tex. Civ. App. 560 (Tex. Civ. App. 1894), 26 S.W. 99, 101, as its authority. *Hammonds* suggests that the domicile of the spouses (perhaps even a change of domicile) is irrelevant if the land has its situs in Texas. In *Hammonds*, the court quoted from *Heidenheimer*:

> The statute of Texas declaring that all property acquired by either husband or wife during the marriage shall be deemed the common property of both will control as to real estate situated in Texas, although the parties may both reside in another state, where a different rule of law may apply to such property.

But the *actual* quote from *Heidenheimer* is:

> The statute of Texas declaring that all property acquired by either husband or wife during the marriage shall be deemed the common property of both, will control as to real estate situated in Texas, although the parties may both reside in another state, where a different rule of law may apply to such property. <u>There was no proof, however, that a different rule of law prevailed in Massachusetts, where Loring and his wife lived</u>.

<u>Note</u>*: The Hammonds court omitted the last sentence in the key paragraph. The Texas court did say that the domicile of the parties is a key factor! However, in the absence of proof of Massachusetts law, the court treated the property in question as community property and explained that the wife had retained her one-half interest upon her husband's death subject only to administration for the debts of the community. It also noted that, even though legal title was in the deceased husband's name, all persons who ". . . deal with it after his death must take notice of whatever community rights there may be in a surviving wife. . . ."*

A later Texas case, *Thayer v. Clarke* (Court of Civil Appeals, Texas 1903), was critical of *Heidenheimer*. It also cites two early Texas Supreme Court cases, *Blethen v. Bonner*, 93 Tex. 141, 53 S.W. 1016, and *Oliver v. Robertson*, 41 Tex. 422, as well as another Texas Court of Appeals decision, *Blethen v. Bonner* (Tex. Civ. App.) 71 S.W. 291.

The *Thayer* opinion states:

> And in all jurisdictions so far as we know, where property is exchanged that received in exchange is held by the same title as that parted with. So, if the husband buy [sic] real

> estate with his separate money, the real estate is his, wherever located. The presumption growing out of the fact of its acquisition during marriage [the community presumption] affects only the burden of proof and is a mere detail which becomes irrelevant when the facts are established.

In that case, the couple was domiciled in New York. The husband purchased land in Texas; his wife later died. The Texas court applied New York law to conclude that the wife had not acquired a community interest in the Texas land, because under New York law, the Texas property was purchased by the husband with his funds.

Note: While there is tax authority that a community property state may deny to nonresidents the attributes of its community property law, it may extend its community property system to nonresidents at least to lands acquired by them within the state. Black v. Commissioner of Internal Revenue, 114 F.2 355 (9th Cir. 1940). However, should land in Texas purchased by a married couple domiciled in a noncommunity property state be Texas community property with all its attributes simply by relying on a presumption and ignoring the fact that purchaser resided in a common law state (i.e., the source of payment – consideration could not have been community property)? The generally accepted "source of payment rule," as well as Texas' traceable mutation rule, indicate the Texas land cannot be community property.

I. Does the Surviving Spouse Get the "Step-Up"?

The Uniform Act codifies the source of payment/resulting trust approach followed by most, if not all, common law states. Thus, in those states, what was community property before being transported into the common law state acquires a new characterization in a common law form as defined by the new state of domicile. Then, upon the subsequent death of the first spouse, the majority view and the Uniform Act both preserve the surviving spouse's one-half ownership in the transported property and its mutations. The real question: Is the surviving spouse's retention of his or her one-half interest in the transported property sufficient to qualify the surviving spouse's one-half interest for the IRC 1014(b)(6) basis adjustment?

In a Field Service Advisory, 1993 WL 1609164 (1993), a California couple sold their California residence and used the sales proceeds to purchase a replacement residence in Oregon (upon presumably moving to Oregon). Oregon had only recently enacted the Uniform Act. The advisory notes that the key factor in all cases is the characterization of the property under controlling state law. It then explains that, under the Uniform Act, the deceased spouse only had testamentary power over one-half of the Oregon property, thereby the surviving spouse retained her one-half interest. The advisory did not state the Oregon replacement residence was community property (because it wasn't under Oregon law). Nevertheless, the advisory stated that both halves of the Oregon property were entitled to the adjusted basis upon the death of the first spouse. It further stated that the purpose of the Uniform Act was to ensure that the surviving spouse would have the same ownership rights in Oregon as she would have had if still domiciled in California. Of course, a field service advisory is not to be used or cited as precedent.

Further, in its revised IRM 25.18.1, dated June 6, 2017, the IRS stated: A community property estate, having been created, is terminated when spouses change their domicile from a community property state to a common law state. 25.18.1.3.4. (03-04-2011). At least one commentator has noted that this observation does not appear to be supported by any authority. Wendy Goffe, *Yours, Mine and Ours: An Introduction to the Laws of the U.S. Community Property States*, ALI-CLE course materials, VCWBD709-ALI-CLE37 (July 9, 2014), § IX.

J. Texas Real Property

In one Texas case, a Texas couple had acquired a community property home in Texas prior to moving to Iowa. In a Texas trespass to try title action involving the home following the couple's divorce in Iowa, the Texas court enforced the Iowa divorce decree, awarding the home to the husband. *Pascoe v. Keuhnast*, 642 S.W.2d 37 (Tex. App.—Waco 1982, writ ref'd n.r.e.). The Iowa divorce court had awarded the Texas home to the husband while being unaware that the wife previously had fraudulently conveyed the home to a friend. In its opinion, the Texas court stated that the home was the couple's community property while they were domiciled in Texas and that it remained their community property even after they moved to Iowa. Then based on the facts and circumstances, the property was awarded to the husband pursuant to the Iowa divorce decree. *In this author's opinion, the court's often cited statement that the property was still community property after the couple moved to Iowa is questionable, and in any event, that the finding that it was still community property was irrelevant to the ultimate decision and should be considered, at best, to be questionable dicta.*

If the community real property that is left behind in Texas after a couple moves to a common law state is no longer community property, the spouses actually own the property as tenants in common (or perhaps joint tenants if they had agreed to rights of survivorship). Thus, it would appear that only the deceased spouse's one-half interest is entitled to receive the adjustment in basis under IRC § 1014(b)(6). However, in Rev. Rul. 87-98 (1987), a couple in a community property state purchased real property in that state with community funds but had its title conveyed to themselves as joint tenants with rights if survivorship (a common law estate); both halves still qualified for the adjusted basis at the first spouse's death since there wasn't any evidence that they had intended to convert the property to separate property. Some commentators suggest that this ruling supports the argument that any community real property that is left behind when a couple moves to a common law state should still receive the full 100% basis adjustment upon the death of the first spouse to die.

The weakness in that argument is the actual language in the ruling which acknowledged that, under controlling state law, the property was still community property. In addition, the couple did not change their domicile. If under controlling state law, community property had been converted into the spouses' respective separate properties, only the deceased spouse's interest is entitled to receive the adjusted basis. The surviving spouse's one-half interest does not. See *Murphy v. Commissioner*, 342 F.2d 356 (9th Cir. 1965) and Rev. Rul. 68-80, 1968-1 C.B. 348.

K. Texas Conclusions

In Texas, as in other states, the ownership of property acquired during marriage by a married couple is generally determined at the time the property is acquired. If the couple is domiciled in Texas, the property so acquired would typically be either one spouse's separate, the other spouse's separate or the couple's community property, assuming it is real property located in Texas or personal property wherever located. If characterized as community property under Texas law, each spouse owns an equal undivided one-half interest in the property whether the property is titled in one spouse's name or in both spouses' names; if titled in one spouse's name, the other spouse's interest is equitable in nature.

Texas marital property characterization as community or separate affects not only the underlying ownership, but also the "attributes of ownership," such as the spouses' management rights, liability issues and the disposition of the property upon the termination of the marriage either by death or divorce. These attributes are defined primarily by the law of the couples' current domicile. In Texas, these attributes are defined in Title 1 of the Texas Family Code. The Texas Family Code, Section 1.103, states the Family Code applies to persons who are married elsewhere who are domiciled in Texas (suggesting it applies only to those couples domiciled in Texas); <u>it does not state what happens to those couples who were domiciled in Texas but change their domicile to a common law state</u>. But the underlying ownership is typically set as being owned by one spouse or both spouses at the inception of title according the law of the couple's domicile at the time of acquisition, regardless of their current domicile.

In other words, a subsequent change of domicile by the couple does not change the ownership rights of the spouses in such what was their community property regardless of where the assets may be located after the change of domicile. However, a change of domicile does affect the attributes of ownership as originally defined in the Texas Family Code. For example, if after the change of domicile, the couple get a divorce, the divorce court in the state of domicile acquires personal jurisdiction over the couple and will apply its laws in the divorce proceedings.

Note: <u>*Back to the key issue: Following the death of the first spouse, will the surviving spouse be entitled to a "step-up" in the survivor's half of what was their Texas community property? If they are moving to one of the common law states that purports to enable them to retain transported property as "community property," in order to gauge their confidence level that the transported property will be considered to be community property under IRC 1014(b)(6), the couple should request a legal opinion from a lawyer in the common law state that explains how the domiciliary state will define the attributes of ownership of the transported "community property" (management rights, liability rules and disposition upon termination—divorce or death) and how those attributes would compare/differ from owning the property in the state's common law form. If there is a substantive difference, the couple can be more confident that IRC 1014(b)(6) will apply. If there is no substantive difference, perhaps they shouldn't count on it.*</u>

<u>*If it appears that the transported property is "community property" in name only and/or the domiciliary state has adopted the Uniform Act (or perhaps even under the majority source of payment rule), will the IRS rely on the previously referenced Field Service Advisory so that the transported*</u>

property will qualify for the hoped for step-up in basis for both halves of the transported community property under IRC § 1014(b)(6)? Or will the IRS rely on the referenced IRM?

L. Surviving Spouse's Rights

Upon the first spouse's death, the change of domicile may have granted the surviving spouse even greater rights than the spouse would have had if they were still domiciled in the community property state. The surviving spouse may not only retain the survivor's one-half interest in what was community property before the change in domicile, but also claim a "statutory share" in the estate of the deceased spouse under the law of the domicile. The laws of the common law states even vary on the resolution of this issue. Schoenblum, *supra*, at 10:21[D][2]. The Uniform Act recognizes this principle; however, what was the community property may not be subject to the surviving spouse's elective share. *See* Gary, et al., at 661.

APPENDIX

General Entity Concepts

If a spouse owns an interest in a business entity, the marital property character of the interest depends initially on the application of the inception of title rule. The assets of the entity are owned by the entity and are neither separate nor community property. In a sole proprietorship, the assets are owned by the owner and may be separate or community property. Today, partnerships, limited partnerships, limited liability partnerships and limited liability companies are defined by the Texas Business Organizations Code as entities.

It is interesting to note that some commentators have suggested that general partners may be able to agree at the formation of the general partnership to have the partnership treated under the common law's aggregate theory so that the assets are still owned individually by the co-owners.

1. Characterization

   If a spouse owns an interest in an entity, the interest itself is presumed to be community property and the burden of proof is on the spouse to prove by clear and convincing evidence why the interest is separate property. An increase in the value of the entity during marriage and the corresponding increase in value of the interest, regardless of the reason for the increase, generally does not affect the marital property character of the interest itself. See *Jensen v. Jensen*, 665 S.W. 2d 107 (Tex.). Characterization of dividends has been held to be based on the time it was declared, not actually paid since that is when the right to it happens. Presumably, that rule would apply to other entities. Stock received by a spouse by reason of a stock dividend or stock split normally takes the marital character of underlying shares.

   <u>Note</u>: *In any separately-owned, closely-held business enterprise where a spouse is involved in the management, Jensen v. Jensen, 665 S.W. 2d 107 (Tex. 1989), must be factored into the analysis to determine if a claim for community reimbursement exists. According to Jensen, claims for reimbursement can arise because of the expenditures of uncompensated time, talent or labor or contributions of community property to the separate property business.*

2. When and How Acquired

   If the interest was acquired prior to marriage, the interest is the spouse's separate property. Likewise, if acquired during marriage by gift, devise or descent, it is separate property. If the interest is purchased during marriage, it is presumed community property, but the spouse may be able to prove it is separate property by tracing the property used to acquire the interest back to separate property.

3. Initial Formation

   If the entity is formed during marriage, the character of the spouse's interest should depend on the marital property character of the assets originally contributed by the spouse to the entity's capitalization. In a corporate situation, if traceable separate property is contributed in exchange for the shares of stock, the shares are separate property. *Vallone v. Vallone*, 644 SW2d 455 (Tex. 1982). In *Allen v. Allen*, 704 S.W.2d 600. (Tex. App.— Fort Worth 1986 no writ), the spouse incorporated a sole proprietorship that predated the marriage but was unable to prove that the initial capitalization was separate property, even though the business activity before and after the incorporation was essentially the same. Thus, the community presumption prevailed, leaving the owner spouse with a separate claim for reimbursement.

4. Other Entities

   Since limited partnerships and limited liability companies are formed by a filing with the Secretary of State, the marital property characterization of a spouse's interest should parallel the established corporate interest principles. However, the characterization of a general partnership interest may differ. Since there are no formal organizational requirements (only the agreement of the parties), some commentators have argued that a married partner's interest has to be community property since the inception of title occurred at the time of the agreement of the partners to create the partnership and there is not any traceable separate property involved. Others argue that characterization should depend on character of the funds used in the original capitalization like in the other entity situations. A limited liability partnership (LLP) is either a general partnership or a limited partnership that has registered as an LLP, thereby shielding the partners from personal liability for the debts and obligations of the partnership. Registration as an LLP does not "form" the partnership; formation occurs when the partnership is formed as either a general partnership or a limited partnership. Thus, registration as an LLP should not affect the manner in which the characterization of a partner's partnership interest is determined.

5. Distributions of Profits

   A distribution of current earnings by the entity to a spouse owner is community property as income from separate property. In *Marshall v Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987 writ ref'd n.r.e.), even mineral royalty payments, which otherwise would have been separate property of a married co-owner, were community property after the underlying separate ownership was contributed to a partnership. Regarding LLC and partnerships, distributions of profits and from capital accounts are both considered community property. Likewise, a corporation's distribution out of current earnings in the form of a dividend in cash (or in kind) to a married shareholder is community property. Characterization of dividends has been held to be based on the time it was declared, not actually paid, since that is when the right to the dividend occurs. Presumably, that rule would apply to other entities.

6. Retained Earnings

   A corporation's retained earnings generally remain corporate assets and are neither community nor separate property. Likewise, earnings of a partnership retained by the partnership for the reasonable needs of the entity have been held to be neither separate nor community property. *Jones v. Jones*, 699 S.W.2d 583 (Tex. App.—Texarkana 1985, no writ); *McKnight v. McKnight*, 543 S.W.2d (Tex. 1976). However, in either a separately owned "S corporation" or another "flow through" entity situation, the payment of any resulting income tax liability with community funds may give the other spouse a claim for reimbursement.

7. Liquidation

   Assets received in a partial or total liquidation of the entity, including those traceable to earnings from earlier years, should generally be characterized based on the marital characterization of the spouse's interest in the entity in that such a distribution can be characterized as a mutation of the original capital contributions. On the other hand, a distribution from a partner's capital account was community property because it was not a return of the partner's capital. *Lifshutz v. Lifshutz*, 199 S.W. 3d (Tex. App.—San Antonio 2006, pet. denied). Of course, any current earnings so distributed should be community property regardless of the marital property character of the spouse's underlying ownership interest in the entity.

EXHIBIT A

"I Am Moving to Texas"

Once a couple establishes their domicile in a community property state, that state's law governs their marital rights. However, any property acquired while residing in the common law state can (but not necessarily will) maintain its original ownership status. Louis Mezzallo, *Tax Management Portfolio, The Mobile Client: Tax, Community Property and Other Considerations*, 803 (BNA). Reppy, Samuel and Richardson at pages 423-436 discuss the different approaches taken by some of the community property states both during the remainder of the marriage and after its termination by reason of death or divorce.

i. Existing Assets

Once they establish their new domicile, each traceable asset acquired while domiciled in the common law state will remain a spouse's property or they will each own an undivided one-half interest in the property as tenants in common, *assuming the recently attached community property presumption can be overcome by clear and convincing evidence.* Early on, it is likely that ownership of the asset as established in the common law state can be proven, but as time passes, the ability to meet the burden of proof (that the asset was owned prior to the move to the community property state) may be lost.

ii. Future Acquisitions

However, their respective salaries and other forms of compensation will be community property. The income being generated by their respective separate properties will be community property. Any other assets purchased by either spouse while domiciled in Texas will be presumed community property unless proven to be separate property (i.e., traceable to his or her separate property).

iii. Unilateral Gifts and Debts

Any unilateral gifts of community property 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 "fraud on the community" and a breach of a duty owing by the donor spouse to the other spouse. 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 will take advantage of the community presumption.

iv. Divorce

Generally, community property is subject to an equitable division by the divorce court and separate property is not. However, any traceable 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 § 7.001-7.002.

v. Alimony

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 limited situations.

vi. 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 will retain the survivor's separate property and one-half of the community, but will no longer have any elective/statutory share rights. Unlike some states, Texas does not recognize *quasi-community property* at death. *See Estate of Hannau v. Hannau*, 730 S.W.2d 163 (Tex. 1987).

vii. Compare Other States

Some other community property states grant to the surviving spouse an interest in the deceased spouse's *quasi-community property*, which is actually the decedent's separate property. "Quasi-community property is generally defined as marital property acquired while domiciled in a common law state that would have been characterized as community property if the married couple had been domiciled in a community property state." Kenneth W. Kingma, *Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States*, 35 ACTEC J. 74, 82 (2009). *See* Gary, Borison, Cahn and Monopoli, at 661. Generally, the surviving spouse is entitled to an undivided one-half interest in such property, and the remaining one-half interest is subject to testamentary disposition by the deceased spouse. In the event the decedent leaves an incomplete testamentary plan, or dies intestate, all of the decedent's quasi-community property not otherwise disposed of is distributed in the same manner as community property under the laws of intestacy. If the non-owner spouse dies first, however, this spouse possesses no rights in the quasi-community property of the surviving spouse, and the survivor retains this property, free and clear of any claim of the deceased spouse's estate.

viii. Local Counsel

Obviously, the client would be well advised to consult with Texas counsel as soon as they move (perhaps even before they move). Existing estate planning documents need to be reviewed within the context of Texas law. The need for any community property-specific planning should be considered. As should be obvious, joint representation of both spouses is even more problematic in a community property state.

ix. To He_ _ (Double Hockey Sticks) . . . With This!

In view of all of these new complications, the client may wish to "opt out" of Texas' community property regime, a result that can be accomplished in a marital agreement crafted using Texas law. The couple can agree to create a "community free" Texas marriage where all property is the separate property of one spouse or both spouses. *See* Tex. Fam. Code §§ 4.201–4.206.

EXHIBIT B – GREEN AND GOLD ACRES

<u>Texas Couple, H&W, 2 Adult Children</u>

Green Acres	**Gold Acres**
1. Title, "H&W"	1. Title, "H&W"
2. Community property (can partition into tenancy in common); any rental income is community property	2. Tenancy in common (separate property, but can "transmute" into community property); any rental income is community property
3. Joint management	3. Joint and several management
4. If homestead, joint management	4. If homestead, joint management
5. Liable for both spouses' debts	5. A spouse's interest is exempt from other spouse's debts
6. If homestead, generally exempt from both spouse's debts	6. If homestead, generally exempt from both spouses' debts
7. At divorce, subject to equitable division	7. At divorce, remains tenancy in common
8. At first spouse's death, survivor retains her ½ interest	8. At first spouse's death, survivor retains her ½ interest
9. If intestate, survivor inherits decedent's 1/2 (now has fee simple title)	9. If intestate, survivor inherits 1/3 life estate in decedent's ½ (if homestead, survivor has right of possession)
10. Still subject to decedent's debts, if not homestead	10. Survivor's ½ still exempt from decedent's debts; if homestead – decedent's ½ exempt
11. 100% subject to administration (if not homestead)	11. Only decedent's ½ subject to administration (if not homestead)
12. Can avoid probate with "rights of survivorship"	12. Can avoid probate with "rights of survivorship"
13. Decedent's ½ included in gross estate, but 100% gets "step-up" in basis (even if decedent devises decedent's ½ to the children)	13. Decedent's ½ included in gross estate, but only decedent's ½ gets "step-up" in basis (even if decedent devises decedent's ½ to survivor, who then has fee simple title)