MARITAL PROPERTY CHARACTERIZATION OF INTERESTS IN AND DISTRIBUTIONS FROM BUSINESS ENTITIES AND EXPRESS TRUSTS

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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. The marital property character of those interests and distributions becomes 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. Previously Existing

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

2. Gratuitous Transfers

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

3. Marital Partitions

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

4. Certain Credit Acquisitions

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. Personal Injury Recoveries

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

6. Traceable Mutations

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. Premarital Partitions

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

2. Spousal Partitions

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. Income from Separate Property

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. Spousal Donations

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. Separate Property

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

2. Sole Management Community

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. Joint Management Community

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. Presumption

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. 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. *See* II, D, *supra*.

V. 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. Definition

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. Creation

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. Revocable or Irrevocable

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.

Note: *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 VI, 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* VI, 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. Ascertainable Standard Limitation

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. <u>The Unanswered Questions</u>

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.

VI. 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. See VI, C, infra..*

Note: If the husband in Land 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).

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.